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Donald E. Schwartz

Financial Reporting of Diversified Companies: Legal Implications*

By DONALD E. SCHWARTZ**

The Needs of Investors and the Economic Setting

OUR economic structure grows increasingly complex. Both its size and its shape have changed radically in 35 years. There wages a steady struggle to comprehend it and to cope with it. Government, essentially conservative and pragmatic, seeks to apply tested methods to new phenomena. The modern diversified, or conglomerate, company is an example of such a new phenomenon.

Both legal and business considerations have accelerated the tendency of corporations to grow by diversification and in the form of conglomerate companies. Corporate growth results both from acquisition and from internal sources. Growth by acquisition of companies in the same business encounters serious anti-trust impediments which may, indeed, rule out any significant horizontal combination.[1] Vertical combinations, too, run into serious opposition from anti-trust authorities.[2] However, the same anti-trust rules are not applicable to combinations which are neither horizontal nor vertical.[3] Thus, while conglomerate mergers do not, by any means, enjoy anti-trust immunity,[4] such combinations are judged by a more flexible policy since they do not have the same impact on the market structure as do horizontal and vertical combinations.[5] It is interesting to observe

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** Associate Professor of Law, Georgetown University Law Center.

1 *See* United States v. Von's Grocery Co., 384 U.S. 270 (1966).

2 Clayton Act § 7, 15 U.S.C. § 18 (1964); *see* United States v. E.I. du Pont de Nemours & Co., 353 U.S. 586 (1957); United States v. Yellow Cab Co., 332 U.S. 218 (1947).

3 Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313, 1315-16 (1965).

4 *Cf.* FTC v. Proctor & Gamble Co., 386 U.S. 568 (1967); U.S. DEP'T OF JUSTICE, MERGER GUIDELINES (May 30, 1968), *reprinted in* 1 TRADE REG. REP. ¶ 4430, at 6681 (1968).

5 Bison, *The Von's Merger Case—Antitrust in Reverse*, 55 GEO. L.J. 201, 231 (1966).

that the proliferation of conglomerate mergers has prompted the Federal Trade Commission to undertake a study to see "whether new legislation is necessary to bring the conglomerate merger movement under control."[6]

The legal compulsion for an acquisition-minded company to seek combinations with companies engaged in diverse businesses coincides with management thinking that this is sound business policy. For example, Litton Industries, Inc., the most diversified large conglomerate company,[7] has told its shareholders: "The day of the old business maxim of putting your eggs in one basket and watching that basket, is gone forever."[8]

The business approach of diversifying by moving into several fields is applicable whether growth results from acquisition or from internally generated sources. Litton's explanation for growth in this fashion is the desire to exploit opportunities in fields previously overlooked because they were unrelated to the company's traditional business. Research capabilities, as in the case of du Pont, can lead a company into several fields.

Another motive for diversification may be to attempt thereby to reduce risk and stabilize profits. A company which manufactures military aircraft, for example, is vulnerable to political changes. It can reduce that risk by developing capabilities for the manufacture of office equipment, or by acquiring an office equipment company. The tobacco companies have chosen this means of reducing the risk of investment in their companies. A company which is in a low profit field, such as a railroad, may find better profit opportunities for its excess capital in a new and unrelated business. A company's managerial skills may be broader than its current business activities, or it may be necessary to acquire the needed skills as it enters new fields.[9]

Investor interest in conglomerate companies has at times been feverish, as the stock prices of such glamor conglomerates as Litton, Ling-Temco-Vought, ITT, Gulf & Western Industries, FMC, and Textron,[10] to name merely a few, have illustrated periodically. This, in turn, creates a managerial drive to become a conglomerate company, or to be recognized as one, in order to be in position to realize the

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6 Wall Street Journal, July 25, 1968, at 1, col. 6, at 12, cols. 1-3 (Western ed.).

7 O'Hanlon, *The Odd News About Conglomerates*, FORTUNE, June 15, 1967, at 175.

8 1966 LITTON INDUSTRIES ANN. REP. 4.

9 *See* Blair, *The Conglomerate Merger in Economics & Law*, 46 GEO. L.J. 672 (1958).

10 O'Hanlon, *The Odd News About Conglomerates*, FORTUNE, June 15, 1967, at 175, 177.

rewards which accompany stock market favor.[11] The market can turn on its former favorites, as it did with conglomerates following Litton's report of lower earnings for the first time in its history in early 1968, but the investor interest in conglomerates has not been extinguished.

The federal securities laws had as their original purpose the disclosure of full and accurate information for use by investors.[12] This purpose has not changed in 35 years. The information may be used for various decisions—whether to purchase securities, whether to vote for management or opposition, whether to hold or sell a security at a particular price. Essential to most of the decisions is detailed financial information, principally a balance sheet and a profit and loss statement.[13] The financial reporting requirements of the securities laws have not changed radically as modern economic life has changed. While we seek to retain the best of tested methods, in the conservative and pragmatic spirit mentioned, we must ask whether our old methods continue to serve our present needs. Specifically, it must be determined whether, by complying with the present federal securities laws, conglomerate or diversified companies are furnishing sufficient and appropriate information to investors to fulfill the purposes of those laws.

The prevailing practice of diversified companies is to disclose the results of operations of the aggregate enterprise. Litton, for example, reported that its 1967 revenues were $1,561,510,000, of which 31 percent were generated by business equipment and supplies, 32 percent by defense and space systems, 27 percent by industrial systems and equipment, and 10 percent by professional products and services.[14] However, there is no comparable allocation of the $70,070,127 of net earnings. Moreover, the four groups of activity selected by Litton comprise perhaps 18 separate business activities.[15] Further, while there are some companies that do break down net earnings by divisions or product lines, as discussed subsequently, many, if not most, diversified companies disclose less information than does Litton.[16] The problem this creates, in the opinion of the Securities

[11] The desire to get in step is illustrated by the comment of the Chairman of the Board of Tenneco., Inc., following his company's acquisition of Kern County Land Co.: "We're a conglomerate—and we should be compared with them rather than other pipeline companies." *Management—Tenneco Lands Kern County*, BUS. WEEK, July 22, 1967, at 97.

[12] 1 L. LOSS, SECURITIES REGULATION 127 (2d ed. 1961).

[13] Bradley, *Auditor's Liability and the Need for Increased Accounting Uniformity*, 30 LAW & CONTEMP. PROB. 898, 910 (1965).

[14] 1967 LITTON INDUSTRIES ANN. REP. 55.

[15] O'Hanlon, *The Odd News About Conglomerates*, FORTUNE, June 15, 1967, at 175, 175-76.

[16] One study of financial reporting of 70 diversified companies revealed

and Exchange Commission (SEC), was stated by Chairman Manuel F. Cohen as follows:

> The most important change, as you are of course well aware, is the growing tendency toward absorption of separate industrial enterprises into large conglomerate companies. Each time one of these enterprises is absorbed, and ceases to publish separate financial statements, the available information about the industry in which that enterprise is engaged is correspondingly reduced. Acceleration of the trend toward absorption of these independent enterprises makes it increasingly difficult for investors and others to draw intelligent conclusions about the affairs and prospects of companies in the particular industries—of either the conglomerate companies or of independent companies. This creates a very real threat to the ability of independent investors to reach informed investment decisions, which Congress has recognized as a basic prerequisite to a healthy securities market.[17]

It is in this context that the SEC is giving consideration to increasing the amount of financial information required to be disclosed by diversified companies. Chairman Cohen has questioned whether "we should be looking toward a defined operating profit and loss statement on a division basis as the next objective beyond the breakdown of sales for the conglomerate company."[18] Further details are lacking as to the methods by which the information would be disclosed, or the precise additional information which would be required, but in essence the Commission would require companies engaged in diversified businesses to give some detail as to the profitability of the various material segments of the company.

Primarily as a result of the concern expressed by the SEC, the Financial Executives Institute undertook a study, through its research arm, the Financial Executives Research Foundation, to determine whether expanded financial reporting would be desirable, and, if so, to determine the best means of achieving it. The SEC deferred

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that only 10 made any breakdown of net earnings, but this was considered an unrepresentatively high percentage of the number sampled since the 10 were chosen for the reason that they made such breakdown and were not the result of a random selection. M. BACKER & W. MCFARLAND, EXTERNAL REPORTING FOR SEGMENTS OF A BUSINESS 41-64 (1968) (research study of National Association of Accountants). The Wall Street Journal reports that the number of conglomerates which will furnish profit breakdowns should increase from 17 to perhaps 60 this year, but even this larger number is relatively small. Wall Street Journal, August 5, 1968, at 1, col. 6, at 13, cols. 1-2 (Western ed.).

17 *Hearings on S. Res. 191 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong. 2d Sess. pt. 5, at 1983 (1966) [hereinafter cited as *Economic Concentration Hearings*].

18 Address by Manuel F. Cohen, Chairman, SEC, before the Nineteenth Annual Conference of the Financial Analyst Federation, May 24, 1966, in *The SEC and Accountants: Co-operative Efforts to Improve Financial Reporting*, J. ACCOUNTANCY, Aug. 1966, at 57, 60 [hereinafter cited as Cohen Address before the Financial Analyst Federation].

promulgation of any new rules until the study was completed. The study was directed by Dr. Robert K. Mautz, professor of accounting at the University of Illinois, and its extensive findings and recommendations were published in July, 1968.[19] In essence, the report found a need for extended disclosure by certain companies and recommended means by which it should be met. Similar recommendations were made earlier by the American Institute of Certified Public Accountants (AICPA),[20] and the National Association of Accountants.[21] These reports, and the increase in extended reporting on a voluntary basis, are certain to affect the substance of the SEC's proposals.[22]

The Commission's response to the changes brought on by the emergence of conglomerate companies as an important economic factor has certain legal implications which must be carefully explored. Expanded disclosures will mean that companies, and perhaps their auditors, will have additional requirements to meet. These additional requirements may present more serious risks of legal liability than now exist. The gravity of these duties and risks is the nub of the question presented here. The perspective of this inquiry should be a desire to fulfill the goals of the securities laws without imposing legal consequences so drastic as to make the game not worth the candle. As Dr. Mautz pointed out in his study, "those who are responsible for published financial statements must never forget that they may be held liable for the reliability and understandability of the data which they issue. Heavy legal responsibility is part of the environment in which financial executives and Certified Public Accountants live . . . ."[23]

Substantial business and accounting problems have been raised which question the desirability of the SEC proposal;[24] indeed, the earliest objection to product line reporting came from the SEC itself.[25] The answers to these questions will in turn depend partly on the

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19 R. MAUTZ, FINANCIAL REPORTING BY DIVERSIFIED COMPANIES (1968) [hereinafter cited as MAUTZ].

20 Accounting Principles Board, *Disclosure of Supplemental Financial Information by Diversified Companies*, J. ACCOUNTANCY, Oct. 1967, at 52.

21 M. BACKER & W. MCFARLAND, EXTERNAL REPORTING FOR SEGMENTS OF A BUSINESS (1968).

22 *See* 33 SEC ANN. REP. 45 (1967).

23 MAUTZ 21.

24 Sommer, *Conglomerate Disclosure: Friend or Foe?*, 22 BUS. LAW. 317 (1967); Bows, *Problems in Disclosure of Segments of Conglomerate Companies*, J. ACCOUNTANCY, Dec. 1966, at 33; Goodrich, *Executive's View of Corporate Reporting Responsibilities*, FINANCIAL EXECUTIVE, Dec. 1966, at 16; Greer, *The Chop Suey Caper*, J. ACCOUNTANCY, Apr. 1968, at 29; Rappaport, *Problems in Product Line Reporting*, 48 LYBRAND J. 3 (1967).

25 SEC Memorandum of June 4, 1965, *appended to Economic Concentration Hearings*, pt. 2, at 1069-71 (1965).

manner in which the SEC exercises the broad authority which it possesses.

Clearly, difficult definitional and judgmental problems of an accounting nature are created by a proposal for product line reporting.[26] Pertinent questions in this area are: Which companies will be affected? which product lines or product line groupings will be reported separately? and in which manner will joint costs and other expenses attributable to several product lines be allocated? Balance sheet allocations would be necessary to calculate return on investment, and that may be more perplexing than the income statement problems.[27] The SEC has made no reference to balance sheet information, despite its significance to the information required.

Management is concerned that extended disclosures will involve additional costs, will benefit competition, and will not provide commensurate benefits to investors.[28] To a great extent, these objections flow from the accounting difficulties involved. Many of these difficulties are concerned with the determination of which segments of a business should separately report sales and profits.

Dr. Mautz has noted that several methods are available whereby a diversified company could report the financial status of its various operations. These methods include breakdowns by: (1) legal entities, (2) units within a company's own organizational chart, (3) a company's products, and (4) the various industries in which a company is engaged.[29] Dr. Mautz favored the last of these alternatives, with the classification of the industries to be made by management.[30] Certainly, such a practice might carry the requirement of extended reporting beyond the so-called "conglomerate" company, a term which, itself, may be difficult both to define and to identify.[31]

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[26] Halvorson, *Accounting Aspects of Conglomerate Reporting*, 23 Bus. Law. 549 (1968).

[27] *See* Sommer, *Conglomerate Disclosure: Friend or Foe?*, 22 Bus. Law. 317, 329 (1967).

[28] Mautz 60 *et seq.*

[29] *Id.* at 46.

[30] *Id.* at 128. Throughout this article the term "product line reporting" will be used to refer to extended reporting or reporting by segments. Its use is indicative merely of the proposed change in reporting requirements and is not intended as evidencing disagreement, or agreement, with Dr. Mautz' views on the proper basis for segmenting a diversified company.

[31] The difficulty with confining expanded disclosure to those companies which may be defined as "conglomerate" is illustrated by the following observation: "Should multi-market companies be required to report in more detail than they now do? Maybe they should—but the reasons advanced apply to a great many companies that aren't ordinarily thought of as conglomerates, and their advancement suggests, again, the extent of prejudice against conglomerates. The main contention, of course, is that when a company is in many different markets and industries, it is hard for investors to have any

In addition, management is concerned with the possibility that allocation of joint costs may be required. Some financial executives have pointed out that the allocation of joint costs between various segments of a business is necessarily arbitrary and that consequently investors would be confused or, worse, misled by such an allocation. As noted earlier, however, Chairman Cohen proposed the reporting of a "defined profit"[32] which would leave the joint costs unallocated. One business objection to this proposal has been that the resulting "defined profit" will not enlighten investors and thus that reporting of a "defined profit" would achieve none of the purported benefits of extended disclosure but would merely impose all of its disadvantages.

The objective should be to achieve a pattern of financial reporting which will result in optimum disclosure to the marketplace without unduly burdening those who report. The achievement of that objective necessitates a careful analysis of why aggregate reporting of sales and profits is inadequate, if that is the case, and of what can be gained from some sort of breakdown.

Rationale of Product Line Reporting

It should be noted that while the proliferation of diversified companies is relatively recent, there is nothing new in the quest for more refined financial reporting. Thus, it was argued in 1939:

> Investors are not so much interested in whether income comes from the sale of goods or from the sale of services, as they are in knowing from *what goods and what services* the income is derived. For instance, in the income statement of General Motors, it would be far more important for investors to know the percentage of gross revenue derived from the sale of each line of cars, the percentage derived from the sale of Frigidaires, and from the corporation's other major activities than to know that a certain amount was derived from the sale of 'goods' and the remainder from the operation of a railroad. In large corporations, with many diversified types of activity, the disclosure of net sales and operating revenues, costs of goods and services sold, and net operating income in total figures is not particularly enlightening to the investor. In fact, the larger the corporation and the more activities it engages in, the less significant gross revenue figures will be to an investor or an investment analyst for purposes of forecasting. *Segregation within these items is necessary for intelligent forecasting and evaluation.*[33]

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clear idea where the profits are coming from. If the objective is to let investors in on what is making money, and what isn't, and what the amounts are, then the discussion covers just about all multi-division companies; in fact the requirement would seem to call for some reporting *within* particular divisions." *The Case for Conglomerates*, FORTUNE, June 15, 1967, at 163-64 (editorial).

[32] Cohen Address before Financial Analyst Federation at 60; *see* Halvorson, *Accounting Aspects of Conglomerate Reporting*, 23 BUS. LAW. 549 (1968).

[33] Kaplan & Reaugh, *Accounting, Reports to Stockholders, and the SEC*, 48 YALE L.J. 935, 943 (1939) (emphasis added).

More recently, the need for extended financial reporting to show profitability of at least certain segments of a diversified company was summarized by Dr. Mautz:

> Diversified companies do present special problems to investment analysts, problems both in understanding the extent and nature of their operations and of predicting the future growth and success of such companies. An investor needs to know at least the variety, types and relative importance of the several industries engaged in by such a company in order to evaluate its overall competitive position. Without such an evaluation, any forecast of its future prospects can scarcely be well founded. Quite clearly, one component of a diversified company may have a trend line for profits, for risk or for potential growth which is at variance with development of the other components. Depending upon the importance of the component and the materiality of its difference from the others, this information may be of considerable significance to investors. Such differences are not revealed through combined reporting in a set of consolidated financial statements. Only if the investor has some knowledge of the extent and present effects of such differences, does he have an appropriate basis for anticipating the long term·influence of importance.[34]

It is also interesting to observe that many of the arguments against product line reporting have been urged and rejected in somewhat different contexts at earlier times. American Sumatra Tobacco Company sought confidential treatment of its sales and cost of goods sold for 1937 on the grounds that:

> This disclosure, while of interest to the Corporation's competitors and customers, is not in the public interest and it would have a very serious effect on the prices at which this corporation would be able to sell its products. Because of its one type of industry, the Corporation is not in the position of many companies whose products are diversified and whose statements of sales and costs of sales include many products, thereby not causing these companies to disclose the amount of any particular product left on hand to its competitors and customers.[35]

The irony here is obvious. Today the multi-product company claims it will be harmed by product line reporting, and for the same reasons urged 30 years ago by this single product company. The diversified companies have enjoyed that type of blanket confidential treatment for which American Sumatra petitioned exemption in the SEC's discretion.

The Commission's response rejecting the application bears close reading today. The Commission stated that investors would be benefited by disclosure of sales and profit margins because "in order either to judge the past or to forecast intelligently, an investor must have not only a record of past earnings or losses, but also the significant details as to how the particular results were obtained."[36] The

[34] MAUTZ, *supra* note 19, at 126-27.
[35] American Sumatra Tobacco Corp., 7 S.E.C. 1033, 1038 (1939).
[36] *Id.* at 1041.

particular information sought about sales and cost of sales was important to investors because there was no other way in which they could gauge the effect on profits of changes in selling prices, wage rates, material costs or other fluctuations. The relative size of the gross profit margin was important in that a wide profit margin might mean strength of the company's position if it were attributable to factors which others could not duplicate, but might indicate vulnerability if due to factors which others could duplicate. Similarly, a low gross profit margin could mean management weakness or conditions not conducive to further competition.

Dr. Mautz's observations indicate the relevance of the SEC's position to product line reporting: A company's experience with different segments of its business may show disparities in profitability and hence in risk, growth potential and management capability.[37] If so, the separate profit data of *those* segments is of as much interest to today's investor as were the sales and cost of sales of the single product produced by American Sumatra Tobacco Company, and basically for the same reasons set forth by the Commission in 1939. If the investor is to arrive at the same position the SEC thought desirable almost 30 years ago, he needs more sophisticated tools of analysis than are currently provided by most companies.

How can this goal be achieved by the contemplated proposal for extended financial reporting? Dr. Mautz recommends "flexibility in the fractionalization of diversified companies for financial reporting purposes" and "the placement of the responsibility for such fractionalization where it righfully belongs, squarely upon company management."[38] He suggests that only those segments which comprise 15 percent of the total business be separately shown.[39]

Because of the diversity of possibilities available, as evidenced by the reporting practices of those companies which do furnish extended information, one could scarcely expect comparability of reporting between different companies. Dr. Mautz recommends that, as a corollary of flexibility, there should be a "two-fold responsibilty, first to describe clearly the nature of the profitability figure reported so that those who read it may understand the meaning of what they have presented to them; secondly a responsibility to disclose the methods used in allocating common expenses and/or pricing intra-company transfers if either of these items significantly affected the reported income figure."[40]

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[37] MAUTZ, *Identification of the Conglomerate Company*, FINANCIAL EXECUTIVE, July 1967, at 18.

[38] MAUTZ, *supra* note 19, at 134.

[39] *Id.* at 130.

[40] *Id.* at 138.

The lack of uniformity which may be inevitable in product line reporting is not sufficient reason to reject the proposal that reporting be required. The financial community seems aware of the limitations of extended reporting, and yet its members vigorously urge the need for the information.[41] A leading member of the financial community has said that the lack of comparability is not important; what is important is year to year consistency within a single company whose profit breakdown is tailored to reflect the financial condition of each of its segments.[42]

Two other views as to the desirability of product line reporting deserve mention. The first is that the SEC financial reporting requirements have not benefited investors, and that therefore companies should be free to report as they wish, provided that they tell the public what they are doing. Moreover, it is argued, the proposal to extend financial reporting to require product line reporting by diversified companies is undesirable because it is impossible to allocate joint costs in a meaningful way.[43] This is one economist's opinion, and while it may be shared by others, certainly it is not the prevailing opinion. To deal with it fairly and completely is beyond the scope of this article, but the assumptions herein are to the contrary: that financial reporting has been improved by the SEC and that by and large the investment community has gained from the SEC's efforts. It is conceivable that this viewpoint is wrong; it is, however, in the main stream.

The second viewpoint is voiced by certain groups who have reportedly suggested that those who need to know the information can obtain it by personal inquiry.[44] This position concedes the relevancy of the information, but would limit its availability to a privileged group with special access to insiders. This approach flies squarely in the face of modern developments in the securities laws[45]

41 The views of members of the investment community have been made known from the time of the earliest discussions of product line reporting. *See* testimony of Yura Arkus-Duntov, *Economic Concentration Hearings*, pt. 4, at 1705-06 (1966).

42 Parker, *A View from Management—Comments*, in PUBLIC REPORTING OF CONGLOMERATE COMPANIES 72-73 (1968) (symposium held at Tulane University, Nov. 1967).

43 Benston, *The Effectiveness and Requirements of the SEC's Accounting Disclosure Requirements*, in SYMPOSIUM ON ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES (1968).

44 Letter from Committee on Relations with Securities and Exchange Commission to Clifford V. Heimbrucher, Sept. 2, 1966, at 7, 9 (reporting views of Financial Executives Institute and Investment Bankers Association) (copy on file in the Hastings Law Library) [hereinafter cited as Heimbrucher Letter].

45 *See* SEC v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,251 (2d Cir., Aug. 13, 1968), *aff'g in part* 258 F. Supp. 262 (S.D.N.Y. 1966); Cady,

and must be rejected emphatically.

Thus, the tentative conclusion may be reached that the case for extended financial reporting in some form is persuasive, although the legal risks remain to be explored and, if found sufficiently serious, might lead to a different conclusion.

Implementation of Product Line Reporting and Securities and Exchange Commission Authority

The preceding observations indicate that product line information would be useful—indeed, may be essential—but they do not tell us how to obtain it. The exact proposal of the Commission will have to be considered. No specific implementation of Chairman Cohen's general suggestion has yet been put forth. But in his initial speech on the subject, Chairman Cohen singled out several conglomerate companies which provide a product line breakdown of profits.[46] For the most part, these companies include in the narrative portion of their annual reports the sales and net income of each major product line group of the enterprise. This breakdown does not appear as part of the financial statement of the company and it is not included within the scope of the opinion of the independent auditors. In some cases, the joint costs, such as income taxes, financing charges, overall administrative costs, institutional advertising and research and development costs are allocated between various divisions, and in others the joint costs are not allocated and there is shown instead a net operating profit of each division before joint costs—generally what Chairman Cohen referred to in his speech as "defined profit."[47] In two cases, the allocation of joint costs was certified by independent auditors.[48]

While it is true that the presentation of "defined profit" is all that the Commission has thus far publicly urged, it is not certain that this is the limit of its proposal. Further, the presentation of a "defined profit" would create special problems. Investors, unfamiliar

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Roberts & Co., 40 S.E.C. 907 (1961); Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271 (1965).

[46] Cohen Address before the Financial Analyst Federation, *supra* note 18, at 60. *See also New Disclosures Noted in Annual Reports*, FINANCIAL EXECUTIVE, June 1968, at 68.

[47] "Defined profit" means income before joint costs. The industry response to the SEC's suggestions of the use of "defined profit" has been lukewarm. *See* Heimbrucher Letter, *supra* note 44, at 9.

[48] DOLLY MADISON CORP. ANN. REP. 13, 16 (1967); KAISER INDUSTRIES ANN. REP. 33, 35 (1967). Reporting practices are discussed generally in Hobgood, *Voluntary Disclosure in 1967 Annual Reports*, FINANCIAL EXECUTIVE, June 1968, at 81.

with this kind of report, might find it incomprehensible, or worse, might be misled into thinking they understand something which they do not, and thereby might draw unintended conclusions. The fact that management, aware of the limitations of such statements, is able to make internal use of them does not mean that investors, who are not steeped in the company's affairs, can make similar use.[49] Moreover, different companies will exclude different kinds of costs in arriving at a "defined profit" and comparability between companies might be hindered. Still, a report of "defined profits" would add useful information to the marketplace, if properly understood, and such understanding is likely to develop in time. However, "defined profits" reporting is probably not, and should not be, the ultimate goal sought.

Chairman Cohen testified before a Senate Subcommittee that the Commission possesses sufficient authority under existing law to require the necessary disclosure.[50] This authority could be exercised in several ways by amending any of the forms on which information is presently furnished. Form S-1,[51] the basic registration form under the Securities Act of 1933[52] and Form 10,[53] the basic registration form under the Securities Exchange Act of 1934[54] each require the following information under the caption "Description of Business":[55]

> If the business consists of the production or distribution of different kinds of products or the rendering of different kinds of services, indicate, insofar as practicable, the relative importance of each product or service or class of similar products or services which contributed 15% or more to the gross volume of business done during the last fiscal years.[56]

Companies registered under section 12 of the 1934 Act[57] must similarly disclose changes in the business on an annual basis on Form

[49] Halvorson, *Accounting Aspects of Conglomerate Reporting*, 23 Bus. Law. 549 (1968).

[50] *Economic Concentration Hearings*, pt. 5, at 1986 (1966).

[51] 17 C.F.R. § 239.11 (1968).

[52] Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1964), *formerly* 48 Stat. 74 (1933) [hereinafter referred to in text as the 1933 Act].

[53] 17 C.F.R. § 249.210 (1968).

[54] Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1964), *formerly* 48 Stat. 881 (1934) [hereinafter referred to in text as the 1934 Act].

[55] Form S-1, 17 C.F.R. § 239.11(c) Item (9) (1968); Form 10, 17 C.F.R. § 249.210 Item (3) (1968).

[56] The statutory basis for Form S-1 is Securities Act of 1933, Schedule A (8), 15 U.S.C. § 77aa (1964), which requires disclosure of the "general character of the business actually transacted or to be transacted by the issuer." Section 12(b)(1)(A) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l* (b)(1)(A) (1964) requires the disclosure of the "organization, financial structure and nature of the business."

[57] Section 12(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l* (b) (1964), provides for the registration of securities which are listed on a

10-K[58] unless they have communicated with their shareholders by a proxy statement or an information statement, although comparable information is not required on these forms. These companies must also furnish their shareholders with annual reports, containing two-year comparative profit and loss statements in substantially the form filed with the SEC on Form 10-K.[59]

The registrant must also include a certified financial statement as part of Form S-1, Form 10, Form 10-K, and in some cases Form 8-K,[60] the monthly report under the 1934 Act of particularly significant events, such as a significant acquisition.[61] An uncertified semi-annual profit and loss statement, in rudimentary form, must be filed on Form 9-K.[62] The SEC proxy rules require disclosure of financial information similar to that submitted on Form 10 whenever a merger or acquisition is submitted to a vote of the shareholders. The information must be furnished with respect to each of the companies involved in the transaction.[63]

The SEC's Regulation S-X,[64] governing the content and prepara-

national securities exchange. Section 12(g)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l*(g)(1) (Supp. 1967), provides for the registration of a class of securities if the issuer's assets exceed $1,000,000 and the class of securities is held of record by 500 or more persons.

58 17 C.F.R. § 249.310 (1968).

59 Annual reports are required of all companies registered under section 12 of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l* (1964), since such companies are subject to the proxy requirements of section 14 of the same act, 15 U.S.C. § 78n (1964), and the rules promulgated pursuant thereto, 17 C.F.R. 240.14a-1 to 240.14a-103 (1968). Proxy rule 14a-3(b), 17 C.F.R. § 240.14a-3(b) (1968), requires the furnishing of an annual report to shareholders. The contents of the annual report are not prescribed, except that the financial statements must generally conform to those filed with the Commission in the annual report required by section 13 of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a)(2) (1964), and an issuer which has not previously submitted an annual report to its shareholders under proxy rule 14a-3, 17 C.F.R. § 240.14a-3 (1968), must describe the nature and scope of its business.

60 17 C.F.R. § 249.308 (1968).

61 Certified financial statements are also required in the following registration forms of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1964): Form S-2, 17 C.F.R. § 239.12 (1968) (commercial and industrial companies in the development stage); Form S-4, 17 C.F.R. § 239.14 (1968) (closed-end investment companies); Form S-5, 17 C.F.R. § 239.15 (1968) (open-end investment companies); Form S-7, 17 C.F.R. 239.26 (1968) (certain large listed companies); Form S-8, 17 C.F.R. § 239.16b (1968) (employee offerings); Form S-9, 25 Fed. Reg. 6431 (1960) (non-convertible fixed interest debt securities); Form S-11, 17 C.F.R. § 239.18 (1968) (certain real estate companies); Form S-14, 24 Fed. Reg. 5900 (1959) (securities acquired in a transaction exempt from registration under rule 133).

62 17 C.F.R. § 249.309 (1968) (filed as part of original document).

63 Schedule 14A, 17 C.F.R. § 240.14a-101 Items 14-15 (1968).

64 17 C.F.R. §§ 210.1-01 to 210.12-41 (1968).

tion of financial statements filed with the Commission,[65] requires that if income is derived from both sales and operating revenues, and if either contributes 10 percent to the total, the separate contributions of each category to gross income must be stated.[66] Thus, some allocation of sales and revenues is required presently, but not along lines which would reveal net income of separate product lines.[67]

This look at the requirements of financial statements, as well as the requirements of prospectuses and annual reports, is important because the Commission is not overlooking the possibility of extending product line reporting to financial statements. Thus, Chairman Cohen told the Senate Antitrust and Monopoly Subcommittee that:

> Up to now, however, except in the case of companies selling both goods and services, we have had no general requirement that conglomerate companies break down their financial statements to show results of operations for their different divisions. As our 1965 memorandum set forth, there are a number of reasons why we did not do so. But, changes have been occurring recently which have made it necessary for us to reconsider our requirements in this area despite the difficulties we will have to face.[68]

Subsequently, Mr. Cohen told the American Institute of Certified Public Accountants (AICPA) that "if most of the net income came from a product line which accounted for only half of the sales, I am not sure that financial statements which do no more than report sales, cost of sales, expenses and net income for the two divisions 'fairly present' the results of operations of the company for that year."[69]

Before both the Senate Subcommittee and the AICPA, Mr. Cohen cited the recent English example of requiring companies en-

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65 Except for Form 9-K, 17 C.F.R. § 249.309 (1968); *see* rule 1.01 of Reg. S-X, 17 C.F.R. § 210.1-01 (1968).

66 Rule 5.03 of Reg. S-X, 17 C.F.R. § 210.5-03 (1968).

67 The Securities Act of 1933 may have contemplated an allocation of sorts, while the Securities Exchange Act of 1934 omits any reference to allocations. Schedule A(26) of the Securities Act of 1933, 15 U.S.C. § 77aa (1964), requires "a profit and loss statement of the issuer showing earnings and income, the nature and source thereof . . . ." Section 12(b)(1)(K) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l*(b)(1)(K) (1964) merely states that there shall be filed "profit and loss statements for not more than the three preceding fiscal years," which shall be certified if required by the Commission.

68 *Economic Concentration Hearings, supra* note 15, pt. 5, at 1987 (1966).

69 Address by Manuel F. Cohen to the 79th Annual Meeting of the AICPA, Oct. 5, 1966, in J. ACCOUNTANCY, Dec. 1966, at 59 [hereinafter cited as Cohen Address before the AICPA]. This is an important, if surprising, observation in view of the fact that thousands of financial statements have purported to "fairly present" the results of operations by reporting in the manner Mr. Cohen now questions, and the SEC has not heretofore objected. But changing times create changed needs and expectations, and the significance of Mr. Cohen's questioning such an established practice may serve to emphasize the strength of the Commission's feelings on this subject.

gaged in substantially different kinds of businesses to describe separately the proportions into which sales are divided among the various groups and the extent to which separate components have contributed to profit or loss of the whole enterprise.[70] Moreover, even if the Commission initially does not require any changes in the financial statement, it may eventually do so.[71]

All the forms which require either a description of the company's business or a financial statement result from a statutory mandate to the Commission to promulgate such forms.[72] There exists sufficient authority under these statutes to amend the forms so as to require either a narrative presentation of the results of separate product line groups or the inclusion of such results in a financial statement.[73] Moreover, the Commission could require that product line results be certified by an independent accountant, or it could omit the requirement of certification, in whole or in part.[74]

There is also broad statutory authority given to the Securities and Exchange Commission to prescribe accounting standards. Under both the 1933 Act and the 1934 Act, the Commission has authority to determine "the items or details to be included in the balance sheet and earnings statement."[75] For the most part the authority has been unexercised,[76] but this residual power could be employed

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70 GUIDE TO THE ACCOUNTING REQUIREMENTS OF THE COMPANIES ACTS 1948-1967, at 25 (1968) (published by Gee & Co., Ltd., London, for the General Educational Trust of the Institute of Chartered Accountants in England and Wales).

71 The research report of the National Association of Accountants argues that investor confidence in reports of separate segments of a business will be increased if buttressed by the auditor's opinion. The study suggests guidance for coping with the difficulties concededly involved in such a recommendation. M. BACKER & W. MCFARLAND, EXTERNAL ACCOUNTING FOR SEGMENTS OF A BUSINESS 101-02 (1968).

72 Securities Act of 1933 §§ 7, 10, Schedule A(8), (26), 15 U.S.C. §§ 77g, 77j, 77aa Schedule A(8), (26) (1964); Securities Exchange Act of 1934 §§ 12(b)(1)(A), (K), 15 U.S.C. §§ 77l(b)(1)(A), (K) (1964).

73 Rule changes must comply with section 4(a) of the Adminsitrative Procedure Act, 5 U.S.C. §§ 1101-11 (1964), *formerly* 60 Stat. 237 (1945), which requires notice of the proposed rule and an opportunity for interested parties to be heard. *See* SEC Rules of Practice IV(b), 17 C.F.R. § 201.4(b) (1968) as to the type of notice required.

74 The Securities Exchange Act of 1934 has no requirement of certification for the financial information furnished on Form 9-K, 25 Fed. Reg. 3552 (1960); Form S-10, 17 C.F.R. § 239.17 (1968) (oil and gas royalty interests); Form S-12, 31 Fed. Reg. 7740 (1966) (American Depository Receipts); Form S-13, 17 C.F.R. § 239.25 (1968) (voting trusts); Form 1-A, 23 Fed. Reg. 4455 (1958) (Regulation A offerings under the Securities Act of 1933).

75 Securities Act of 1933 § 19(a), 15 U.S.C. § 77s(a) (1964); Securities Exchange Act of 1934 § 13(b), 15 U.S.C. § 78m(b) (1964).

76 *See* L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE § 3.1 (rev.

to require product line reporting in financial statements filed with the SEC.[77]

Effect of Product Line Reporting on Compliance with Securities Laws

The burden of compliance with any new standards imposed by the Commission will fall on both registrant corporations and their auditors. How great this burden would be depends, of course, on the content of any new rule. At a minimum, registrants and accountants would be required to decide whether product line reporting was applicable to them at all, which product lines should be separately shown and how the results should be described. Since the SEC is charged with assuring compliance with any changes in existing rules, its means of enforcing compliance should be examined.

The Commission has authority under the 1933 Act to issue a stop order if it "appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading."[78] If, for example, Item 9 of Form S-1[79] were amended to require certain companies to indicate sales and income by product lines, a stop order could be issued if the company erroneously (in the Commission's view) decided that the provision was inapplicable.[80] Of course, the Commission does not proceed in that manner, since deficiencies and alleged deficiencies normally are discussed and cured informally by means of a letter of comment and amendment.[81] Nonetheless, the Commission's power to take the matter to a formal proceeding could be used to compel registrants to produce the additional data. Of course, this assumes that the report of product line results would constitute a "material" fact, which indeed seems to be the thrust of the Commission's view, provided that either the sales or profits (or losses) of the separate

2d ed. 1966). Mr. Rappaport also says that the SEC may be asserting its authority even over financial statements not filed with the Commission. *Id.* § 23.13.

77 This might cause annual reports which are furnished to shareholders, and which are not filed with the Commission, to show product line results, since the financial information contained in the annual report must conform essentially to the financial statements which are filed with the Commission on Form 10-K, or the differences must be noted and explained. Proxy rule 14a-3, 17 C.F.R. § 240.14a-3(b)(2) (1968).

78 Securities Act of 1933 § 8(d), 15 U.S.C. § 77h(d) (1964).

79 17 C.F.R. § 239.11(c) Item 9 (1968) ("Description of Business").

80 The Commission's staff frequently has interpreted Item 9 to require sales and earnings information on a product line basis. Most registrants voluntarily comply.

81 1 L. Loss, Securities Regulation 272-77 (2d ed. 1961).

product line were of sufficient magnitude.[82]

Assume, however, that the registrant agrees to show results of its separate product lines or divisions, but in a manner at variance with the views of the Commission staff. Or assume that its allocation of joint costs differs from the view taken by the Staff. The ground in this area is largely untrod. Enough has been said by accountants and corporate executives to demonstrate the wide and difficult areas of judgment involved in such breakdowns and allocations.[83] There exist at present few guidelines to assist in making these judgments. Conceivably the Commission might exercise its power to provide fixed rules, although this would be a departure from past and current practices.[84] Failing that, reasonable judgments by registrants would seem sufficient to avoid a stop order.[85]

If the Staff could use the threat of a stop order to compel product line reporting, it is fair to ask whether it is likely that it would employ the same threat to compel breakdowns and allocations in a manner favored by the Staff. In fact, this would seem to be unlikely. It is one thing to tell a company that more information is required and quite another to dictate the contents of the disclosure. It is presumed that the Commission and the Staff, both acting in good faith, would not insist upon one way to do something when there are clearly tenable alternatives.[86] This would be a still more radical departure from past and current practice.[87]

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82 *See* testimony of Manuel F. Cohen before the Economic Concentration Hearings, *supra* note 17, pt. 5, at 1988 (1966).

83 Greer, *The Chop Suey Caper*, J. ACCOUNTANCY, Apr. 1965, at 27; Halvorson, *Accounting Aspects of Conglomerate Reporting*, 23 BUS. LAW. 549 (1968).

84 Cohen Address before the AICPA, *supra* note 69, at 56.

85 Wide latitude to management in making the difficult choices was suggested as the proper SEC stance by Dr. Blair, the chief economist to the Senate Antitrust and Monopoly Subcommittee, on the occasion of Chairman Cohen's testimony. *Economic Concentration Hearings, supra* note 17, pt. 5, at 1991 (1966). The need for flexibility is urged strongly in Mautz, *Bases for More Detailed Reporting by Diversified Companies*, FINANCIAL EXECUTIVE, Nov. 1967, at 52, 60. Flexibility seems, at this point, to have been accepted by the SEC. Barr, *Comments on the Conglomerate Reporting Problem*, FINANCIAL EXECUTIVE, Nov. 1967, at 39.

86 MAUTZ ch. 2; *see* Sprouse, *Chop Suey, Chain Stores and Conglomerate Reporting*, J. ACCOUNTANCY, Apr. 1968, at 35.

87 *See, e.g.*, SEC Accounting Series Releases [Acct. Ser. Rel.] No. 96 (Jan. 10, 1963), where the Commission says: "In recognition of the substantial diversity of opinion which exists among responsible persons in the matter of accounting for the investment credit, the Commission will accept either a method which reflects the investment credit in income over the productive life of the acquired property or a method which reflects 48% of the investment credit (the maximum extent to which the credit can normally increase net income) in income as a reduction of the tax expense of the year in

The Commission's power to compel compliance with the 1934 Act reporting requirements stems primarily from its power to suspend trading in a company's security. The exercise of this power is conditioned upon a determination by the Commission that "the public interest so requires"[88] in the case of listed securities and that "the public interest and the protection of investors so require" in the case of a security traded over-the-counter.[89] The suspension is for a maximum of 10 days, but the order of suspension can be renewed every 10 days indefinitely.[90] The Commission has made increased use of this power since 1964, when it was extended to over-the-counter securities.[91] While the statutory standard is vague, the principal cause for a suspension of trading has been the inadequacy of the information provided on Forms 10-K and 8-K filed with the Commission. Hence, if the Commission required product line reporting, and if a report filed with the Commission failed to comply with the requirements, the Commission could compel the filing of an amended report by suspending trading until such a report was filed.

The Commission has always been particularly concerned with the contents of financial statements. It has held that financial statements will be "presumed to be misleading" if they are prepared "in accordance with accounting principles for which there is no substantial authoritative support."[92] Thus, if either as a result of SEC requirements or of voluntary decision, the breakdowns and allocations relating to product line reporting were to appear in a company's financial statement, this concern would make it incumbent upon both the registrant and the auditor to make judgments for which a reasonable basis would be required.

What constitutes such "substantial authoritative support" is unclear.[93] But it is clear that reliance on a current practice or custom

which the credit arises and defers the balance of 52% to subsequent accounting periods during which depreciation allowances for tax purposes are reduced because the statutory requirement reduces the basis of the property for tax purposes by the amount of the investment credit . . . . In all cases full disclosure of the method of accounting followed and amounts involved should be made where material."

88 Securities Exchange Act of 1934 § 19(a)(4), 15 U.S.C. § 78s(a)(4) (1964).

89 Securities Exchange Act of 1934 § 15(c)(5), 15 U.S.C. § 78o(c)(5) (1964).

90 For example, trading in Westec stock on the American Stock Exchange has been suspended since August 29, 1966. SEC Securities Exchange Act of 1934, Release No. 7945 (Aug. 29, 1966).

91 Securities Exchange Act of 1934 § 15(c)(5), 15 U.S.C. § 78o(c)(5) (1964).

92 SEC Acct. Ser. Rel. No. 4 (Apr. 25, 1938).

93 L. Rappaport, SEC Accounting Practice and Procedure § 2.7 (rev. 2d ed. 1966).

that the Commission deems inadequate lacks "substantial authoritative support."[94] A certifying accountant who so places his reliance incurs the risk of disciplinary proceeding under Rule II(e) of the Commission's rules of practice.[95] Hence, the extension of product line reporting into the company's financial statements is likely to spur the accounting profession toward the development of generally accepted accounting principles dealing with breakdowns of product lines and allocation of costs.

Although there are at present no authoritative guidelines for reporting product line results,[96] some standards do exist,[97] and work apparently is progressing toward the development of the necessary understanding and skill.[98] One accountant has written: "The kind of product-line information needed for external reporting is generally accumulated anyway for managerial purposes. Depending upon internal accounting procedures, disclosure may require some reclassification but will not entail substantial effort or outlay."[99]

That view is not representative of the accounting profession, however.[100] While it is probably true that product line information is prepared for management, those readers of such a report have a sophistication about the company's affairs which outside investors could not hope to emulate. Consequently, management reads the report with sharp awareness of its arbitrary aspects and its limitations. It must be acknowledged, therefore, that much effort must still be expended before guidelines can be produced which will assist in the preparation of a report of comparable usefulness to the general public. This effort has been spurred by the special report of the Accounting Principles Board, which recognizes the usefulness of the

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94 Interstate Hosiery Mills, 4 S.E.C. 706 (1939); *In re* McKesson & Robbins, Inc., SEC Acct. Ser. Rel. No. 19 (Dec. 5, 1940); *see* Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437, 1460 (1967).

95 17 C.F.R. § 201.2(e) (1968).

96 Rappaport, *Problems in Product Line Reporting*, 48 LYBRAND J. 1, 7 (1967).

97 The chairman of the AICPA's special committee to study product line reporting has written that management has developed cost techniques to enable it to judge relative profitability of products, and consequently charge each division with its share of overall joint costs. Bows, *Problems in Disclosure of Segments of Conglomerate Companies*, J. ACCOUNTANCY, Dec. 1966, at 33, 35.

98 *See* Mautz, *Identification of the Conglomerate Company*, FINANCIAL EXECUTIVE, July 1967, at 18; Sommer, *Conglomerate Disclosure: Friend or Foe?*, 22 BUS. LAW. 317 (1967).

99 Schachner, *Corporate Diversification and Financial Reporting*, J. ACCOUNTANCY, Apr. 1967, at 43, 50.

100 The AICPA committee appointed to study the project disagrees with Professor Schachner. Heimbrucher Letter, *supra* note 44, at 3.

information and urges companies voluntarily to disclose supplemental financial information as to industry segments of the business.[101]

Despite the serious nature of the administrative sanctions at the SEC's command, the risks of seeking to comply with product line reporting requirements do not seem severe; at least they should not seriously be increased. Registrants and accountants must develop further their skills in making meaningful breakdowns of product lines and allocations of joint costs to suit the particular needs of investors. But the increased incidence of diversified companies, more than any new SEC rules, will necessarily accelerate this development.

Product line reporting constitutes the adoption of a general rule or a general policy requiring disclosure of information which may adversely affect a company. The argument has been made that product line reporting will, in fact, adversely affect reporting companies with respect to competitors and customers, since some information, currently confidential, might be included within the required disclosure.[102] The 1934 Act currently contains a provision which, if utilized, could avoid such harm by allowing confidential disclosure of information.[103]

Confidential treatment should be granted in appropriate cases, where the registrant can demonstrate a reasonable likelihood of harm.[104] The Commission previously has rejected an application for confidential treatment of sales and profits of a single product company, as noted earlier,[105] and that position was affirmed in court.[106] However, the court observed that the Commission sought the reporting of this information solely on the basis of the facts presented to it. The court added that if the Commission had sought justification of its position as a general rule or a general policy, "the case would have been different and would have demanded different treatment."[107]

The remarks of the Court of Appeals might well serve as a caution to the Commission that such applications should be viewed sympathetically. The fact remains, however, that the Commission always has been chary in granting applications for confidential treatment, and there is little reason to expect liberal treatment in this area.

It should further be observed that confidential treatment of mat-

101 Accounting Principles Board, *Disclosure of Supplemental Financial Information by Diversified Companies*, J. ACCOUNTANCY, Oct. 1967, at 51.

102 Rappaport, *Problems in Product Line Reporting*, 48 LYBRAND J. 1, 6 (1967).

103 Securities Exchange Act of 1934 § 24(b), 15 U.S.C. § 78x(b) (1964).

104 MAUTZ, *supra* note 19, at 73, 142.

105 See text accompanying notes 35-36 *supra*.

106 American Sumatra Tobacco Corp. v. SEC, 110 F.2d 117 (D.C. Cir. 1940).

107 *Id.* at 121.

ters contained in a financial statement or in the text of a document setting forth product line results can be sought only with respect to matters filed under the 1934 Act. Companies offering their securities pursuant to a 1933 Act registration statement can seek confidential treatment only for matters contained in a contract.[108]

Civil Liabilities of Corporations and Their Personnel

The most serious implications of product line reporting are in the area of potential civil liabilities of companies, their officers, directors and controlling persons, and auditors. The problem of the corporation, its officers, directors and controlling persons will first be considered.

Since their adoption, the Federal securities laws have been the basis of most actions against corporations arising from the purchase or sale of securities. A concept of "federal corporation law" has emerged from these cases. Areas previously thought to be solely the concern of state regulation have been brought within the scope of federal law through the liability provisions of the federal securities laws.[109] In recent years this has been especially true, owing to the proliferation of actions brought under rule 10b-5,[110] promulgated under the 1934 Act. To what extent, if at all, will product line reporting increase the hazards of liability?

The potential liability of corporations will be: (1) to those persons who acquire securities from the company directly and those who acquire securities sold pursuant to a 1933 Act registration statement, (2) to persons who purchase or sell securities in the marketplace from other investors, and (3) to shareholders. Both specific statutory liability provisions and implied but well recognized[111] remedies must be considered.

Liability to Purchasers

Insofar as the potential liability to purchasers under a registration statement is concerned, the specifically applicable statute is section 11 of the 1933 Act.[112] This section renders the issuer liable to any person who acquires such security if the registration statement

108 15 U.S.C. § 77aa Schedule A(30) (1964); 17 C.F.R. § 230.485 (1968).

109 Katz & Schwartz, *Civil Liabilities Under Rule 10b-5*, in DISCLOSURE REQUIREMENTS OF PUBLIC COMPANIES AND INSIDERS 302 (J. Flom, B. Garfinkel, & J. Freund eds. 1967); Fleischer, *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965).

110 17 C.F.R. § 240.10b-5 (1968).

111 Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947); *cf.* Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966); J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

112 Securities Act of 1933 § 11, 15 U.S.C. § 77k (1964).

contained "an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ." The liability may arise in a transaction in which the company is the seller, or in a secondary distribution. Liability also extends to persons who signed the registration statement (which include the principal executive and financial officers), all directors, the underwriters and experts, and by virtue of section 15,[113] controlling persons. There are, however, certain defenses against liability which are available to all these persons except the issuer.[114]

Section 12(2) of the 1933 Act[115] is not limited to securities sold under the registration statement, as is section 11. Section 12(2) makes the seller liable to any person purchasing securities from it, if a representation is made "which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . ."

In the context of a corporation's liability resulting from product line reporting, section 11 is more pertinent than section 12(2). The time of delivery of a prospectus is the only time at which the company is likely to make direct representations when it sells its securities. Most misrepresentations by corporations are likely to be made indirectly, through the required registration statement. Since section 11, which is stricter than section 12(2), is applicable to the registration statement situation, recourse should be under that provision. Open market transactions, on the other hand, normally will not involve the company as a representing party, and since section 12(2) liability is limited by a privity requirement, difficulties in this context generally will not arise. Of course, in the case of a privately negotiated sale exempt from the registration requirements of the 1933 Act,[116] section 12(2), and not section 11, would then be applicable, thereby covering any representations made in a private contract.

Product line reporting will require some companies to disclose more than they are now disclosing. Since there is a risk that they will misstate the required information, their chances of incurring liability will be increased. The issuer who *deliberately* misstates the information is not really of concern in this context. Such an issuer will be subject to liability under either common law or federal law[117] if a misstatement relates to a material fact. Thus, this discussion is

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113 Securities Act of 1933 § 15, 15 U.S.C. § 77o (1964).
114 Securities Act of 1933 § 11(b), 15 U.S.C. § 77k(b) (1964).
115 Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(2) (1964).
116 Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1964).
117 Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1964).

concerned with the issuer whose misstatement has resulted from inadvertence or mistake, and whose liability will depend on the materiality of that misstatement.

One of the primary objections to product line reporting is that the information to be furnished is not material, since the investor acquires a stake only in the entire company.[118] But the argument that results of separate product lines are not material, even though their filing may be required, is not likely to prevail. As observed earlier, a considerable benefit may accrue to an investor who knows the net profits and profit margins of separate components of the business, as this knowledge helps him to forecast the future performance of the company.[119] Moreover, this knowledge assists the investor in evaluating management's performance—possibly the most important investment variable.[120]

The United States Court of Appeals for the Second Circuit has held that when a company's year-end earnings were accurately presented, but the results of recent months were inflated, a situation which created the false impression of a favorable trend, a material misstatement had been made.[121] The Court said: "Concededly, the profits for the year as a whole were substantially unaffected by the overstatement of December earnings, but the prospective purchaser was entitled to a full disclosure of all the facts that were known to the Corporation at the time the prospectus was issued. . . ."[122]

A similarly prejudicial distortion of the financial condition of a conglomerate company could result from an exaggeration of the earnings reported for one product line, for example, and an understatement of the earnings of another product line. The courts probably will be inclined to view that type of distortion as being equally as objectionable as the misreporting of recent operations. Thus, product line results, if required, will in some cases, and perhaps in most, be viewed as material; and liability could result notwithstanding the accuracy of the aggregate profit figure.[123]

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118 *See* Rappaport, *The Role of the Accountant*, in DISCLOSURE REQUIREMENTS OF CORPORATIONS AND INSIDERS 263-64 (J. Flom, B. Garfinkel & J. Freund eds. 1967).

119 See text accompanying notes 37-38 *supra*.

120 Franchard Corp., SEC Securities Act Release No. 4710 (July 21, 1964).

121 Kaiser-Frazer Corp. v. Otis & Co., 195 F.2d 838 (2d Cir. 1952).

122 *Id.* at 843.

123 "The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." 17 C.F.R. § 230.405(*l*) (1968). What constitutes such information is "a question of judgment to be exercised by the trier of fact as best he can in the light of all the circumstances." Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 682 (S.D.N.Y. 1968).

To hold that results of a separate product line are a material fact, however, does not by itself present any great peril to the corporation. The computation and reporting of a "defined profit" will not be a particularly burdensome task, although there are some problems, such as those arising from intra-company sales.[124] Thus, if no allocation of joint costs is required or volunteered, the fair presentation of product line results alone should be no cause for fear of increased civil liabilities.

If allocations of joint costs are required, there is a greater margin for error. But it can be assumed that the basis of such allocations will be set forth in the report, as is the current practice.[125] If there is a rational basis for the method chosen, and if the method fairly presents the true financial position of the company, it generally could not be argued that the allegedly offending document fails to make full disclosure.[126] There would seem to be no omission of a material fact, no failure to state a material fact required to be stated, and no untrue statement of a material fact, as those terms are used in sections 11 and 12(2).

For the same reasons, common law rescission would not be available.[127] Certainly under the circumstances described, there is no fraud at common law, as the essential element of scienter is lacking.[128]

In addition, liability is unlikely to be imposed under rule 10b-5. It seems anomalous to permit buyers to bring an action based on a false or misleading registration statement, or a false or misleading representation in another context, under the implied liabilities of rule 10b-5, when there are specified remedies available in the statute for the identical transaction.[129] While this anomaly has been permitted,[130] the Second Circuit, where most of the cases have arisen, has conditioned recovery under rule 10b-5 upon a showing of reli-

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124 Halvorson, *Accounting Aspects of Conglomerate Reporting*, 23 Bus. Law. 549, 555 (1968). The objection to the use of "defined profit" is not with the difficulty in computation, but with the difficulty an investor will have in comprehending its meaning, and with its potentiality for confusion. Rappaport, *Problems in Product Line Reporting*, 48 Lybrand J. 1 (1967).

125 Bows, *Problems in Disclosure of Segments of Conglomerate Companies*, J. Accountancy, Dec. 1966, at 33; Sommer, *Conglomerate Disclosure: Friend or Foe?*, 22 Bus. Law. 317, 321-22 (1967).

126 *See, e.g.*, the treatment of the different methods of reporting the investment credit in SEC Acct. Ser. Rel. No. 96 (Jan. 10, 1963).

127 3 L. Loss, Securities Regulation 1627 (2d ed. 1961).

128 W. Prosser, Law of Torts 700, 715-16 (3d ed. 1964).

129 Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967); 3 L. Loss, *supra* note 127, at 1778-92.

130 Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).

ance[131] and scienter.[132]

Nonetheless, the celebrated *Texas Gulf Sulphur* case,[133] while not involving a civil action for damages, suggested that scienter, in its common law sense, was not required for recovery.[134] Instead, the rule was said to impose a standard encompassing negligence as well as active fraud. The court said that the rule preserves the standard sometimes referred to as "fraud," which includes what are variously termed lack of diligence, constructive fraud or unreasonable or negligent conduct.[135] But even under such an expansive view of what constitutes actionable misconduct, it seems unlikely that a corporation and its managers who present product line information and allocate joint costs, fully disclosing what they are doing and why, will be exposed to any real danger of liability under rule 10b-5.

Further, as regards section 11, although the issuer's liability is without regard to scienter and generally without regard to reliance,[136] liability is not so strictly imposed upon other persons under

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131 List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965). Reliance may be a plastic concept, however, since an allegation of fraud under rule 10b-5 seems to permit shareholders to sue derivatively on the basis of a failure to disclose material facts to shareholders, even though the corporate act did not require shareholder approval. *See* Entel v. Allen, 270 F. Supp. 60 (S.D.N.Y. 1967). This eliminates the need for "deception" in the conventional sense. *See* Dasho v. Susquehanna Corp., 380 F.2d 292, 267 (7th Cir.) (concurring opinion), *cert. denied*, 389 U.S. 1005 (1967). Another view is that deception is still an indispensable element of the violation, but in some instances the knowledge of directors will not be imputed to the corporation, as in the case of a conflict of interests by a majority of the board. Although the corporate activity in question does not require shareholder approval and can be approved by the board acting alone, disclosure to the board alone will not suffice and, absent disclosure to shareholders, the corporation will have been deceived. *See* Schoenbaum v. Firstbrook, CCH FED. SEC. L. REP. ¶ 92,218 (2d Cir., May 29, 1968). Moreover, since a violation may occur where there is total non-disclosure, it may be that reliance in such a situation is deemed to have been placed on the adequacy of the state of information generally known.

132 Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Weber v. C.M.P. Corp., 242 F. Supp. 321 (S.D.N.Y. 1965). *Contra*, Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). *See* Note, *Proof of Scienter Necessary in Private Suits Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070 (1965).

133 CCH FED. SEC. L. REP. ¶ 92,251 (2d Cir., Aug. 13, 1968).

134 Others have noted that scienter has come to mean nothing more than negligence. A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 (1968).

135 SEC v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,251, at 97,183, 97,187 (2d Cir., Aug. 13, 1968); *see* Comment, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950) (section 106 provided no affirmative defense).

136 *But see* Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1964), where it is set forth that a showing of reliance is necessary where an issuer, subsequent to the issuance of a registration statement containing a material mis-

this section. Controlling persons can avoid liability by showing that they made a reasonable investigation and had reasonable grounds to believe, and did believe, that there was no untruth or misleading statement in the registration statement.[137] If the alleged defect was purported to be made by an expert other than the officers or directors (such as by an accountant) they may avoid liability by showing that they had no reasonable ground to believe, and did not believe, that there was any untruth or misleading statement in the registration statement,[138] or that the statement did not fairly represent the statement of the expert.[139] These defenses, and the defenses in section 12(2) which provide for the avoidance of liability in the event that the defendant did not know and, in the exercise of reasonable care, could not have known of the untruth or omission, all of which are in the nature of good faith defenses, should afford protection in the circumstances described.

The defendant directors in *Escott v. BarChris Construction Corporation*,[140] however, were denied the due diligence defenses of section 11 when they accepted without question or investigation the assurances of management that the representations in the prospectus were accurate and did not inquire as to specific statements. If a prospectus makes allocations of joint costs, those who made the judgments involved should be prepared to show that there is a basis for the choice, but the other potentially liable persons should not be required to determine independently whether the basis is reasonable. Of course, if other information which they possess, or should possess, would demonstrate that the choice is unreasonable, they should be held accountable. The *BarChris* case has caused much soul searching in the financial community.[141] Nonetheless, that portion of the prospectus in which joint costs are allocated, dealing as it does with the *interpretation* of facts rather than with the presentation of raw data, would appear to be one of the least troublesome to potential defendants.

Some problems remain, stemming from the lack of uniformity that may result following a requirement of product line reporting. There is an obligation, of course, that the company's operating results be fairly presented in the report or in the text of a prospectus. The selection of the proper method for reporting should be chosen

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statement, makes available an earnings statement covering at least 12 months beginning after the date of the registration statement.

137 Securities Act of 1933 § 15, 15 U.S.C. § 77o (1964).

138 Securities Act of 1933 § 11b(3)(A), 15 U.S.C. § 77k(b)(3)(A) (1964).

139 Securities Act of 1933 § 11b(3)(C), 15 U.S.C. § 77k(b)(3)(C) (1964).

140 283 F. Supp. 643 (S.D.N.Y. 1968).

141 The American Bar Association conducted a two day symposium devoted exclusively to consideration of the case in New York, Sept. 27-28, 1968.

with this obligation clearly in mind. Increased effort has been exerted in recent years to produce greater uniformity in accounting methods in order to reduce confusion and increase comparability.[142] Adherence to uniform methods probably would reduce the risks of liability as well.

Product line reporting, at least in its early stages, will be a step toward greater diversity and away from uniformity. This diversity has not, by itself, been a hazard to reporting companies, but caution must be exercised. A method of reporting, proper under some circumstances but selected with the intent to obfuscate, could result in liability.[143]

Liability to Persons in the Marketplace

The second source of potential liability of the company and its managers is to persons in the marketplace generally. Product line reporting would furnish information not only in those transactions to which the company is a party, as discussed in the preceding section, but also in open market transactions between parties not necessarily connected with the initial sale. It could be expected, therefore, that the Commission would require product line results to be "filed" with the Commission in the Company's registration statement under the 1934 Act on Form 10[144] and in its annual reports on Form 10-K.[145]

Defective Reporting

The information reported on these forms is intended for use in the marketplace, and the company is subject to potential civil liability under section 18 of the 1934 Act[146] for any statement which is "false or misleading with respect to any material fact" contained in a document filed with the Commission, without regard to whether it was a buyer or seller of securities. Potential defendants under this section include also any person who makes, or causes to be made,

142 Flynn, *Uniformity in Financial Accounting: A Progress Report*, 30 LAW & CONTEMP. PROB. 623 (1965).

143 Professor Bradley has asked, "do not the company and the auditor fraudulently lead the reader into error when the facts presented to him for his analysis can be fully expected, and indeed are designed, to convey an impression that is inadequate and unreliable and when the true significance is impossible to capture without painstaking explanation? Even conservative courts may soon be persuaded that management and auditor ought to be held accountable where this characterization of their conduct proves apt." Bradley, *supra* note 13, at 911.

144 17 C.F.R. § 249.210 (1968).

145 17 C.F.R. § 239.310 (1968). Results on anything except an annual basis might be extremely difficult to prepare and would be of minimal value; hence no interim reports are likely to be sought.

146 Securities Exchange Act of 1934 § 18, 15 U.S.C. § 78r (1964).

false or misleading statements. In addition, controlling persons may be liable unless they acted in good faith and did not induce the acts constituting a violation.[147]

Section 18 is probably the most unavailable of all the liability provisions in the federal securities laws. A recital of the requisites for liability makes it clear why there has never been a successful recovery under the statute. The plaintiff must show that he relied on the alleged false or misleading statement and that his reliance was the cause of his damage. Moreover, all defendants can avail themselves of the defense of good faith and lack of knowledge of the false or misleading character of the statement. Thus, it would appear even more likely than under the 1933 Act that a separate product line report which disclosed the basis upon which it was prepared would not be subject to liability under section 18 of the 1934 Act.

Plaintiffs may seek to avoid the burdens of section 18 by suing under rule 10b-5. Again, as in the case of liability for statements in a 1933 Act registration statement, it is not clear whether a false or misleading statement contained in a document filed with the Commission and potentially the basis for liability under section 18 entails the risk of liability under rule 10b-5, and no court has ruled on the question.[148] In fact, rule 10b-5 more closely resembles section 18 than it does section 11 of the 1933 Act, and the anomaly of dual remedies is even more striking. Even if rule 10b-5 is available, however, no recovery under the circumstances hypothesized should be available, as there would seem to be a full disclosure and a lack of scienter.

Omission to Report

It has been assumed that the companies required to show product line results will recognize the need to comply and will honestly attempt to do so. But the obligation to report may not always be clearly recognizable. Thus, a company's failure to show any results of separate product lines must be considered. It is more realistic to imagine this situation in a context other than that of a public offering by a company under the 1933 Act, where the SEC staff always carefully examines the filing. Filings under the 1934 Act do not receive the same attention as do 1933 Act filings,[149] and the omission of product line reporting may more easily escape detection.

Section 18 liability potentially exists in these circumstances, but recovery would be difficult for the reasons mentioned above. Rule

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147 Securities Exchange Act of 1934 § 20a, 15 U.S.C. § 78a (1964).

148 The issue was raised, but not resolved. Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964). *See Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 869 (1967) (remarks of Professor Jennings).

149 Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1353 (1966).

10b-5, however, contains fewer obstacles to recovery. An investor might thus seek recovery against the corporation for a failure to report by product lines where such omission was material and there existed a duty to disclose.

Would the existence of the reporting requirement increase the risk that the corporation, by remaining silent, would be failing in its duty to investors? The contours of rule 10b-5 are not firmly fixed, but certain observations can be made. The rule is limited to conduct in connection with the purchase or sale of securities, though this limitation has been construed broadly.[150] In cases where neither the company, nor its insiders, nor anyone whom the company is aiding or abetting[151] is engaged in the purchase or sale of securities, rule 10b-5 has not yet been extended so far as to render a company liable in damages for its silence or even for misrepresentation, although injunctive relief has been granted.[152]

Thus, a requirement of product line reporting would not seem to affect the liability of the company whose activities merely affect market transactions, particularly since due diligence and good faith are

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[150] Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970 (1967); SEC v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,251 (2d Cir., Aug. 13, 1968). The early cases restricted action to buyers or sellers, but the rule may now have broader applicability. The law in this area is confusing, and the early somewhat rigid approach was recently reasserted, after *Vine v. Beneficial Fin. Co., supra*, in Greenstein v. Paul, 275 F. Supp. 604 (S.D.N.Y. 1967), *aff'd* CCH FED. SEC. L. REP. ¶ 92,262 (2d Cir., Aug. 30, 1968).

In *Vine v. Beneficial Fin. Co., supra*, the SEC asked the court to rule that a plaintiff need only be a person whose stock lost value as a result of the violation, but the court found no need to rule on this point. 374 F.2d 627, 636 (2d Cir. 1967).

[151] Brennan v. Midwestern Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966).

[152] SEC v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,251 (2d Cir., Aug. 13, 1968). Conduct may be violative of the rule without the defendant having been engaged in securities transactions. *Id.* at 97,187. In *Texas Gulf Sulphur*, the company did not remain silent, but issued a press release alleged to have been false and misleading. Injunctive relief was sought. *Id.* at 97,185.

Conduct violative of the rule has resulted in an injunction, although damages were denied where the company was neither purchaser nor seller. Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967). *But see* Heit v. Weitzen, No. 31157 (2d Cir., Oct. 3, 1968) (Medina, J.), where the corporate defendant had not engaged in buying or selling, but had issued a statement which had market impact. The plaintiff sought damages under rule 10b-5 for misrepresentation, and the court, on appeal from the granting of the defendant's motion to dismiss, reversed and remanded.

The SEC to date has not alleged that total silence by a corporation which is neither buying nor selling securities violates rule 10b-5. Moreover, omission of product line results from a published report may not constitute "total silence."

relevant to the question of a company's violation of rule 10b-5.[153] When a company is neither totally silent in omitting product line information from a report or statement nor actively engaged in market activities, directly or indirectly, the possibility of liability under rule 10b-5 would appear remote. The plaintiff in such a case would shoulder the heavy burden of proving both lack of due diligence in a matter involving judgment and the effect of the defendant's omissions on the market.[154] He therefore would be unlikely to succeed except in the most extreme case of disregard for fair and just financial reporting.

On the other hand, the obligation of the corporation and its insiders to disclose material facts on those occasions when they do trade in the company's securities exists apart from any requirement to file prescribed information with the Commission.[155] Certainly it should not come as a shock if a court were to find that product line reporting in a given case was such a material fact, whether or not the SEC had adopted any rule changes.[156] Nonetheless, the likelihood of a finding that product line reporting constitutes a material fact would be increased if the SEC compelled the furnishing of the information on any of its forms. Therefore, the problem of liability under rule 10b-5 does present perhaps the most serious liability question created by product line reporting. It suggests either that careful guidelines, as explicit as the rules reasonably can be made, should be adopted by the Commission and by the AICPA[157] in order to minimize the area of uncertainty surrounding the obligation to report and the classification of reporting components, or that the standards be made sufficiently flexible to permit management to choose safely between reasonable alternatives, as recommended by Professor Mautz.[158]

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153 SEC v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,251 (2d Cir., Aug. 13, 1968).

154 *Id.*

155 *Id.*; Cady, Roberts & Co., 40 S.E.C. 907 (1961).

156 The closer the case, the less likely the fact of separate product lines will be found material. Clearly, an electronics operation and a cement operation are separate product lines, and their separate results are likely to be material facts. However, companies should have little difficulty in recognizing this fact and reporting separate operations. Whether different geographical operations constitute separate product lines is a harder question, but at the same time, separate results of those operations are not as likely to be material.

157 The Accounting Principles Board preliminary recommendations seem to focus on "those segments of the business which are clearly separable into different industry lines." AICPA, *Disclosure of Supplemental Financial Information by Diversified Companies*, J. ACCOUNTANCY, Oct. 1967, at 51. This standard, almost by definition, would obviate the recognition problem.

158 MAUTZ, *supra* note 17, at 158.

Liability to Shareholders

Thus far, we have considered the potential liability of corporations to investors. It is also necessary to see whether the corporation is exposed to an increased threat of liability to its shareholders.

The proponents of product line reporting have spoken mainly of its value to potential buyers and sellers of securities. But in fact, it may play a role in proxy contests and in other matters submitted to a vote of shareholders. In the case of a contest, the proxy statement used by either party does not contain an item comparable to Item 9 of Form S-1 or Item 3 of Form 10, describing the company's business.[159] However, an annual report must be furnished to shareholders and the financial statements contained therein are expected to conform basically to the financial statements filed with the Commission.[160] Hence, if product line reporting is required in the Form 10-K financial statements, the same information should be expected to be given to shareholders.[161] Although the proxy rules require the distribution of the annual report to shareholders, the report is not considered "filed" for purposes of liability under section 18, nor is it considered a solicitation subject to the proxy regulations.[162] As a result, neither section 18 nor the proscription of rule 14a-9[163] against the inclusion of any false or misleading statement contained in a document "subject to this regulation" and the implied civil liability under that rule[164] would apply to statements appearing in an annual report.[165]

Statements contained in an annual report could cause possible liability under rule 10b-5, but only in connection with the purchase or sale of securities, and hence not in an election contest.[166] If management omits product line reporting in the annual report it distributes to shareholders during a proxy contest and thereby conceals either its own inefficiency or some other reason to vote for the insurgents, no action could be maintained under federal law whereby the election could be set aside. On the other hand, if the soliciting

159 See text accompanying notes 51-56 *supra.*

160 17 C.F.R. § 240.14a-3(b) (1968). *See also* 17 C.F.R. § 240.14*l*-3 (1968).

161 Even if the proxy rules did not require the inclusion of a product line reporting in the annual report sent to shareholders, it seems likely that once management was compelled to disclose it to the SEC, and thereby make the information public, it would elect to include comparable information in the report sent to shareholders. Moreover, the New York Stock Exchange would be likely to require it of listed companies under these circumstances.

162 17 C.F.R. § 240.14a-3(c) (1968).

163 *Id.* § 240.14a-9(a).

164 J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

165 Heit v. Weitzen, 260 F. Supp. 598 (S.D.N.Y. 1966).

166 *See* Fleischer, *"Federal Corporation Laws": An Assessment,* 78 HARV. L. REV. 1146, 1157 (1965).

material,[167] which unlike the annual report is subject to the regulation,[168] contained any false or misleading statements about product line results, a federal claim would exist, as is the case at the present time.[169] Moreover, in an action brought under state rather than federal law, false or misleading statements in an election contest could cause the setting aside of the election,[170] and a state court would not be inhibited, as would the federal courts, by the fact that the misrepresentation appeared in an annual report rather than in a document labelled a proxy statement.

In certain other solicitations subject to the proxy rules, the company is required to include financial information in the proxy statement. If shareholders are asked to vote on the issuance of securities, the modification or exchange of outstanding securities, or a merger, consolidation, acquisition of another company or a dissolution of their own company, the company must furnish appropriate financial statements in the proxy statement.[171] In any such transaction, the proscription of rule 14a-9 and rule 10b-5[172] would be applicable to any product line reporting that might be required in a proxy statement or a financial statement. Further, if the registrant company combines with another company, it must disclose in the text of the proxy statement the nature of the business of the other company,[173] which requirement might be amended to include product line results.

As noted in connection with other documents,[174] however, a company which discloses the basis on which it reports will not face a serious risk of liability. Although the greater danger is faced by the company that omits any product line reporting for itself or the acquired company, the likelihood that this omission would cause an appreciably greater risk of liability than exists under present law appears remote. What potential liability does exist would be imposed in a derivative suit, based on violation of the Commission's rules, against the corporate officers for damage to the corporation, rather than in a suit against the corporation for damage to an individual

[167] 17 C.F.R. § 240.14a-3(a) (1968).

[168] *Id.* § 240.14a-9.

[169] SEC v. Okin, 48 F. Supp. 928 (S.D.N.Y. 1943); *see* E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 154 (2d ed. 1968).

[170] Wyatt v. Armstrong, 186 Misc. 216, 59 N.Y.S.2d 502 (Sup. Ct. 1945).

[171] 17 C.F.R. § 240.14a-101 Schedule 14A, Item 15 (1968) (financial statements).

[172] The enumerated transactions all appear to involve the purchase or sale of securities. *See* Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977 (1967).

[173] 17 C.F.R. § 240.14a-101 Schedule 14A, Item 14(b)(1) (1968) (mergers, consolidations, acquisitions and similar matters).

[174] Text accompanying notes 125, 147 *supra*.

shareholder. The plaintiffs in such a suit presumably would seek to set aside the transaction and perhaps to recover damages from the officers and directors for an improvident transaction. They might succeed if product line results, required or not, which were not made available to shareholders, reflected the inexpediency of the transaction. On the other hand, nondisclosure of the performance of product lines might not be judged as affecting the decision-making of shareholders. In that event, liability is not likely to be imposed even if the omission contravenes a technical requirement that the information be furnished.[175]

But, as noted, product line reporting might disclose errors in judgment of management. Thus, if an acquisition turned out badly, the error would be revealed, whereas at present the performance of the acquired company could be concealed. Or, product line reporting could show a large loss in a developmental program and encourage an action for waste.[176] To the extent that product line reporting poses a serious new threat[177] to management from an increased incidence of shareholders derivative suits, thereby deterring management's venturesomeness, there may be a social loss.[178] But while there is no way of knowing if there would be an increase in litigation, there does not seem to be any real danger of increased liability. Directors presently are required to exercise due care and diligence in the discharge of their duties. They are not liable for losses due to imprudence or honest errors of judgment.[179] The burden of proving the lack of such care rests with the plaintiff,[180] who must also show that the director's negligence was the cause of the loss.[181] If,

175 *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 680-82 (S.D.N.Y. 1968); Richland v. Crandall, 262 F. Supp. 538, 553 (S.D.N.Y. 1967).

176 Sommer, *Conglomerate Disclosure: Friend or Foe?*, 22 Bus. Law. 317, 328 (1967). *See G.E.'s Edsel*, Forbes Magazine, Apr. 1, 1967, at 21.

177 It is possible that under state law a shareholder could obtain such detailed information. ABA-ALI Model Bus. Corp. Act § 46 (1953).

178 One industry group indicates that this request would "inhibit the kind of courage and risk taking by top management that is the very essence of both corporate and national progress and in which the individual investor certainly has a profound interest. The net effect of product-line reporting could be to increase information for shareholders but to reduce the profits in which they are primarily interested." Machine and Allied Products Institute, Top Management Looks at Product-Line Reporting 9 (1967). The pamphlet also perceives "a great danger in too great a preoccupation with the interests of the shareholder." It contends that management's responsibility embraces a wider range, and includes concern for employees, customers, suppliers and the public. The SEC's Chief Accountant found this last a "startling statement." Barr, *Comments on the Conglomerate Problem*, Financial Executive, Nov. 1967, at 39.

179 H. Ballantine, Corporations § 63a (rev. ed. 1946).

180 *Id.* § 63b.

181 Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924). In a transaction re-

however, as a result of product line reporting, management exercises greater care in important transactions, there would be a social gain. Chairman Cohen has urged that such disclosure

> serves as an important control on corporate managers by requiring them to justify the results of their stewardship. There may be diversified companies which are maintaining low-profit or money-losing operations for reasons which would not be persuasive to stockholders or financial analysts and requiring separate disclosure might well result in the improvement or elimination of the sub-standard operation, to the ultimate benefit of the stockholders and the economy generally.[182]

One group has questioned whether management might be liable in a shareholder's derivative suit for disclosing product line results which are helpful to competitors.[183] This would appear to be a wholly imaginary fear. It has not deterred a growing number of companies from volunteering such information. The position of management is vastly strengthened when such disclosure is made as a consequence of a legal duty to do so; at that point management's risk becomes that of failure to disclose.[184] As the SEC said of a fiduciary's duty: "This relationship could not justify any actions by him contrary to law."[185]

Liabilities of Accountants

Since the most difficult problems resulting from product line reporting are accounting problems, it is especially important to see how the civil liabilities of accountants would be affected. In view of the recent increase in lawsuits against accountants,[186] this examination comes at an appropriate time.

The role of the independent accountant is central to the administration of the federal securities laws. Congress rejected a proposal in 1933 for the review of financial statements of filing companies by government auditors, in favor of certification by independent public accountants.[187] The Commission has observed: "The responsibility of

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quiring shareholder approval, it is difficult to see how the directors' negligence can be the cause of the loss, provided, of course, that there is full disclosure.

182 Cohen Address before the AICPA, *supra* note 69, at 59.

183 Letter from Committee on Corporate Reporting of Financial Executives Institute to Manuel F. Cohen, Chairman, SEC, Sept. 16, 1966.

184 *See also* MAUTZ, *supra* note 19, at 73; Sommer, *Legal Aspects of the Recommendations on Financial Reporting by Diversified Companies*, in MAUTZ 381.

185 Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961). *See also* 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1046 (1965). Professor Scott says that a trustee is under no duty to violate the law or act contrary to public policy. 2 A. SCOTT, LAW OF TRUSTS § 165 (2d ed. 1956).

186 Wall Street Journal, Nov. 15, 1966, at 1, col. 1.

187 *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess., at 127 (1933).

a public accountant is not only to the client who pays his fee, but also to investors, creditors, and others who may rely on the financial statement which he certifies."[188]

It is not at all clear that independent accountants will be required to certify anything in connection with product line reporting; in fact, the preliminary indication of the SEC to the AICPA was that no certification would be required.[189] Yet, the problems which might be encountered should be viewed under alternative assumptions. The alternative means of product line reporting which could be required of accountants would be: (1) A description of product line results in the textual portion of a document, (2) information included in a financial statement but not certified by accountants, and (3) information included within a certified financial statement.

Common Law Liability

The common law development affords the background for examining accountants' liabilities. The leading case is *Ultramares Corporation v. Touche.*[190] An accounting firm certified a financial statement which listed fictitious assets. It was conceded that the accountants were unaware of this fraud, but the plaintiff, a creditor of the subject company, who had relied on the financial statement, charged that the accountants were negligent in their audit and were so careless as to be guilty of fraud. Judge Cardozo held that despite the jury finding of negligence, the accounting firm was not liable on this count to the plaintiff. Cardozo said that ordinary negligence could not render the accounting firm liable to anyone except the party with which it had contracted. Any change in this result, he said, would have to be "wrought by legislation,"[191] although he noted that the "assault on the citadel of privity is proceeding in these days apace."[192]

On the question of fraud, or constructive fraud, however, the court held that the jury properly could impose liability in favor of the creditors, as persons within the contemplated use of the financial statement. A subsequent decision of the same court elaborated on this point:

> Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently

188 Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670 (1957).
189 Heimbrucher Letter, *supra* note 44, at 4.
190 255 N.Y. 170, 174 N.E. 441 (1931).
191 *Id.* at 187, 174 N.E. at 447.
192 *Id.* at 180, 174 N.E. at 445.

> gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.[193]

The privity requirement of the *Ultramares* case afforded accountants considerable protection from ordinary negligence. It is doubtful, however, that the requirement remains in full force under common law today. It seems more accurate to say that the common law liability of accountants "extends to those persons for whose guidance the accountant prepares his report and for those transactions in which the report was intended to be used."[194]

Certainly, the common law liability of an accountant is based on the fact that he certified the financial statement.[195] The language of the certificate can limit the scope of this liability by clearly stating that the accountant has not made his own examination, but is relying on the views of others, and that no opinion is expressed with respect to a particular matter in the statement.[196] The financial statements are, after all, the expressions of management,[197] and the auditor's certificate does not of itself signify that the accountant has prepared the statement or has made the judgments necessary for the presentation of the company's financial position.[198] But financial statements are expected to be prepared in accordance with generally accepted accounting principles in order to narrow the range of choices available to management and accountants and hence to make a com-

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193 State Street Trust Co. v. Ernst, 278 N.W. 104, 112, 15 N.E.2d 416, 418-19 (1938).

194 Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 HASTINGS L.J. 436, 447 (1964); *see* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968); RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966).

195 Accountants today do not "certify", they express an "opinion" regarding the financial statement. Some courts, however, have disregarded the difference. Bradley, *Auditors' Liability and the Need for Increased Accounting Uniformity*, 30 LAW & CONTEMP. PROB. 898, 906 (1965). Throughout the opinion in Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), Judge Tyler refers to the accountant's "certificate," although counsel for the accountant had pointed out in its brief that no "certificate" had been given, but that merely an "opinion" was expressed. Evidently this observation was found to be without significance. Brief for Defendants Peat, Marwick & Mitchell at 2 n.1, Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967). Regulation S-X also speaks of the auditor's opinion as a certificate. 17 C.F.R. § 210.2-02 (1968).

196 Beardsley v. Ernst, 47 Ohio App. 24, 191 N.E. 808 (1934); C.I.T. Financial Corp. v. Glover, 224 F.2d 44 (2d Cir. 1955). *See also* Hedley, Byrne & Co. v. Heller & Partners [1964] A.C. 465.

197 Hanson, *Responsibility of Independent Public Accountants*, 22 BUS. LAW. 975 (1967).

198 O'Connor v. Ludlaw, 92 F.2d 50 (2d Cir. 1937); Kountze v. Kennedy, 147 N.Y. 124, 41 N.E. 414 (1895).

pany's statement more meaningful and more capable of comparison with the reports of other companies.[199] If the report does not reflect generally accepted accounting principles, the accountant may be liable if he gives an unqualified opinion.[200] What may constitute a generally accepted accounting principle is a complex question, and the burden may be on the plaintiff to prove what the applicable principles should be and what the statement should have contained.[201]

The striving for increased uniformity in generally accepted accounting principles has been noted.[202] The sources of generally accepted principles are numerous,[203] but probably the most authoritative source today is the Accounting Principles Board (APB) of the AICPA. The objectives of the APB are:

(1) To advance the written expression of what constitutes generally accepted accounting principles;
(2) To determine appropriate practice and to narrow the areas of difference and inconsistency in practice; and
(3) To lead in the thinking on unsettled and controversial issues.[204]

To produce a degree of uniformity on specific issues, accountants are strongly urged by the APB to follow its opinions. The Board has increased its activity recently in response to pressures for uniformity, and has developed authoritative opinions in areas previously noted for their diversity.[205] It would be consistent with its basic objectives for the APB to develop uniformity in product line reporting as soon as the need for uniformity seems required. Apart from other desirable results, this action would reduce the auditor's risk of liability.

There would appear to be little threat of common law liability to the accountant from a requirement of product line reporting. No liability could be imposed unless the statement was certified, and certification, as noted, is not within present contemplation.[206] Even if certification were required, the accountant could disclaim in the certificate any opinion with respect to breakdown of product lines or allocations of joint costs and obviate serious danger of liability other than that resulting from a disregard of some generally accepted ac-

[199] T. WISE, THE INSIDERS ch. 2 (1962); FORBES MAGAZINE, May 15, 1967, at 28.

[200] Teich v. Arthur Anderson & Co., 24 App. Div. 2d 749, 263 N.Y.S.2d 932 (1965).

[201] Blank v. Kaitz, 350 Mass. 779, 216 N.E.2d 110 (1966).

[202] See text accompanying notes 93-101 *supra*.

[203] Bradley, *Auditors' Liability and the Need for Increased Accounting Uniformity*, 30 LAW & CONTEMP. PROB. 898, 899 (1965).

[204] Sprouse & Vagts, *The Accounting Principles Board and Differences and Inconsistencies in Accounting Practice: An Interim Appraisal*, 30 LAW & CONTEMP. PROB. 706, 710 (1965).

[205] Cohen Address before the AICPA, *supra* note 69, at 59.

[206] See text accompanying note 189 *supra*.

counting principle. And even if the statement failed to reflect product line results when such results would be of material value to investors, such an omission would not appear to expose the accountant to danger of common law liability unless some presently non-existent generally accepted accounting principle, dictating such presentation, was ignored.[207]

The honest but erroneous exercise of judgment, especially in view of the auditor's need to rely on management for its information, would seem to preclude the finding of actual or constructive fraud necessary for liability. Moreover, liability has not, as yet, been imposed upon accountants for failure to make a disclosure in the report in situations involving the same difficult areas of judgment presented in product line reporting.[208] The somewhat solicitous attitude toward accountants which the courts have displayed[209] should prevent the imposition of liability except for the most flagrant disregard of the requirement that the earnings statement reflect product line results.

Thus, despite the fact that the pace of the assault on the citadel of privity has quickened, the common law liability of accountants to creditors and investors is still difficult to establish.[210] Accountants would face a genuine problem of liability only if the Commission insisted on an unqualified certificate with respect to product line information. Given the above-mentioned considerations, this requirement would be unjustified, a conclusion reportedly shared by the Commission.[211]

Liability Under Securities Statutes

One of the principal purposes of the federal securities laws was to overcome many of the common law obstacles to civil liability in securities transactions.[212] With the *Ultramares* case recently in the

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207 See text accompanying notes 195-201 *supra.*

208 *Cf.* Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

209 Bradley, *Liability to Third Persons for Negligent Audit,* J. BUS. LAW, Apr. 1966, at 190-195.

210 RESTATEMENT (SECOND) OF TORTS § 402A (1965). The English view of the accountants' responsibility now goes at least as far as the *Ultramares* case and may be even broader. *See* Hedley, Byrne & Co. v. Heller & Partners [1964] A.C. 465 (overruling rationale of Candler v. Crane, Christmas & Co. [1951] 2 K.B. 164 (C.A.)), *noted* in 77 HARV. L. REV. 773 (1964).

Moreover, the American view may be in the process of enlarging accountants' liabilities. The proposal in the RESTATEMENT (SECOND) OF TORTS § 522(2) (Tent. Draft No. 11, 1965) would extend liability to persons for whose benefit the financial statement is intended, and thus, conceivably, would be for the protection of investors. *See* Note, *Accountants' Liabilities for False and Misleading Financial Statements,* 67 COLUM. L. REV. 1437 (1967).

211 Heimbrucher Letter, *supra* note 44, at 4.

212 Shulman, *Civil Liability and the Securities Act,* 43 YALE L.J. 227 (1933).

background, Congress extended the liability provisions of section 11 of the 1933 Act to certifying accountants. Liability is imposed if the effective registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[213] Unlike the issuer, however, the accountant may relieve himself of liability if he can establish that he made a reasonable investigation and had reasonable grounds to believe, and did believe, that the statements were true and that there was no omission of a material fact.[214]

The effect of these provisions was summarized in an article co-authored by one who later became chairman of the SEC, as follows:

> To say the least, the Act goes as far in protection of purchasers of securities as plaintiff in *Ultramares Corp. v. Touche* unsuccessfully urged the New York Court of Appeals to go in the protection of a creditor. The change which that court thought so "revolutionary" as to be "wrought by legislation" has been made. And the duty placed on experts such as accountants has not been measured by the expert's relation to his employer but by his service to investors.[215]

The application of section 11, like that of the common law doctrines, is to statements which the accountant has "certified." The SEC has recognized the special significance of a certified statement:

> A certification is a material fact. It signifies that the contents of the financial statements to which it is appended have been checked and verified within the limits stated in the certificate. To make such certification truly protective of the interests of security holders and investors the requirement under the Securities Act of 1933, as amended, is that it be made by an "independent public or certified accountant." The insistence of the Act on a certification by an "independent" accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of registrants. The history of finance well illustrates the importance and need for submission to such impartial persons of the accounting practices and policies of the management to the end that present and prospective security holders will be protected against unsound accounting practices and procedure and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise which issues the securities. Accordingly, the certification gives a minimum of protection against untruths and half-truths which otherwise would more easily creep into financial statements.[216]

An accountant who certifies a report filed with the Commission under the 1934 Act is potentially liable under section 18 of that statute as a person who makes a statement appearing in a filed document.

213 Securities Act of 1933 § 11(a)(4), 15 U.S.C. § 77k(a)(4) (1964).

214 Securities Act of 1933 § 11(b)(3)(B), 15 U.S.C. § 77k(b)(3)(B) (1964).

215 Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 198 (1933) (footnotes omitted).

216 Cornucopia Gold Mines, 1 S.E.C. 364, 367 (1936).

However, as noted earlier, that section, with its defenses of good faith and no knowledge, has thus far been of no avail to anyone.[217]

In addition, only two reported cases have dealt with accountants' liability under section 11 of the 1933 Act, and in only one case have accountants been held liable. However, it must be asked whether the danger of such liability would be enhanced if certified financial statements were required to show product line reporting. Although the 1933 Act broadened the class of persons to whom accountants were liable for a breach of the duty of ordinary care, the statute did not make the accountant an insurer of the accuracy of the company's financial statement, nor did it, as such, affect the manner in which the accountant discharged his duty to use due care.

In *Escott v. BarChris Construction Corporation*,[218] where the accountants were held liable under section 11, the court stated that "[a]ccountants should not be held to a standard higher than that recognized in their profession."[219] The accountants were unable to show that they had exercised due diligence in performing their audit, but the case did not involve liability for a faulty exercise of judgment. It thus does not seem particularly germane to the problems presented by product line reporting, except insofar as an accountant might face liability for disregarding generally accepted accounting principles or for abdicating his function in deference to the decisions of management.

The other reported case under section 11 involving an accountant is *Shonts v. Hirliman*.[220] In that case, the accountant failed to show in the balance sheet a lease obligation, which did not become fixed and definite until after the date of the certificate. The court held that no liability resulted from this failure, since the books of the company did not show the lease, and the negotiated arrangement was not called to the accountant's attention.[221] *Shonts v. Hirliman* has been criticized sharply by Professor Loss for accepting "surprisingly low accounting standards."[222] He observed that "few reputable accounting firms would be satisfied with a mere perusal of matters coming to their attention through inspection of the books at their disposal."[223] *BarChris* impliedly accepts the more stringent standard

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217 See text accompanying notes 146-48 *supra*. It has been suggested that this section is an adoption of the rule of *Ultramares*, and that accountants are liable only for fraud. S. LEVY, ACCOUNTANTS' LEGAL RESPONSIBILITY 50 (1954).

218 283 F. Supp. 643 (S.D.N.Y. 1968).

219 *Id.* at 703.

220 28 F. Supp. 478 (S.D. Cal. 1939).

221 *Id.* at 483.

222 3 L. LOSS, SECURITIES REGULATION 1733 (2d ed. 1961).

223 *Id.* *See also In re* McKesson & Robbins, SEC Acct. Ser. Rel. No. 19 (Dec. 5, 1940).

in finding a lack of due diligence by accountants who discovered danger signals but disregarded them.[224]

If product line reporting resulted in an erroneous financial statement, it is unlikely that the error would be such as to impose liability on an accountant acting in good faith.[225] The sources of difficulty in preparing such a financial statement are matters of judgment which have not subjected accountants to liability at common law.[226] Even if it is assumed that the *Shonts* case, especially in light of the decisions in *BarChris*[227] and *McKesson & Robbins*,[228] does not reflect modern judicial attitudes toward auditor's duties, the auditor acting in good faith must necessarily rely on many subjective assessments made by others when he certifies a statement containing product line results.

The SEC recognizes that the financial statement is management's representation[229] and that the primary responsibility for its presentation belongs to management.[230] The auditor must inquire of management as to the basis upon which product line reporting has been made (which basis, presumably, will be disclosed in the financial statement) and see that the report constitutes a fair presentation. Management, however, is ultimately responsible for the choice among alternative accounting principles used in presenting the company's financial position.[231] If the accountant makes such inquiry, the defenses available under section 11(b)[232] and section 18[233] should protect him from liability. The accountant who certifies a statement which improperly omits product line reporting incurs a lesser risk than does the company itself. Of course, as generally accepted accounting principles are developed with respect to product line reporting, including standards by which companies and accountants can determine when product line results are required, the auditor must

224 Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 703 (S.D.N.Y. 1968).

225 As in the case of management, our concern is not with accountants who seek to deceive. When the auditors join management in an effort to deceive investors, they become part of the fraud and are liable. Bradley, *Auditors' Liability and the Need for Increased Accounting Uniformity*, 30 LAW & CONTEMP. PROB. 898, 906-07 (1965).

226 See text accompanying notes 208-11 *supra*.

227 Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

228 *In re* McKesson & Robbins, Inc., SEC Acct. Ser. Rel. No. 19 (Dec. 5, 1940).

229 SEC Acct. Ser. Rel. No. 62 (June 27, 1947).

230 Interstate Hosiery Mills Inc., 4 S.E.C. 706, 721 (1939).

231 Bradley, *Auditors' Liability and the Need for Increased Accounting Uniformity*, 30 LAW & CONTEMP. PROB. 898, 905 (1965).

232 Securities Act of 1933 § 11(b), 15 U.S.C. § 77k(b) (1964).

233 Securities Exchange Act of 1934 § 18, 15 U.S.C. § 78r (1964).

face the risk of liability when he ignores such principles.[234]

Regardless of the allocation of liability, a primary purpose of product line reporting is to serve the needs of investors. Whether or not the SEC adopts new rules, auditors must ask whether the statements prepared by the management of a diversified company fairly present that company's operating results and financial position,[235] especially in view of advantages management today claims for diversification. If this need is recognized and filled by management and by auditors, the auditor's risks of civil liability should not be substantial.

Liability Under Rule 10b-5

A requirement that product line results be included in financial statements does not mean necessarily that such results must be certified by independent accountants. If the Commission accepts presentation of the results as supplemental information in the text of a prospectus or a report, the provisions of section 11 and probably of section 18 would be inapplicable to the accountant. The limited applicability of sections 11 and 18 to accountants' liability requires that primary consideration be given to rule 10b-5. The liability asserted by reason of an omission or a false or misleading statement in a certified statement shall first be considered.

Liability from Certified Statement

If the accountant knowingly participates in the preparation of a materially false financial statement, liability exists under rule 10b-5,[236] but this liability is not really an expansion of the risk resulting from a requirement of product line reporting. If the accountant is unaware of any deficiency in the statement, following the exercise of proper accounting standards, the likelihood of liability under rule 10b-5 is remote.

In the case of *Fischer v. Kletz*,[237] an accounting firm remained silent after discovering that the financial statement it had previously certified, and which was filed on Form 10-K, was false. The court refused to dismiss an action by investors against the firm, brought pursuant to rule 10b-5. There was clearly an absence of privity between the plaintiff, an allegedly defrauded purchaser of the stock of Yale Express Company, and the accounting firm. Significantly, there was no assertion in the complaint that the accounting firm "aided and

234 Bradley, *Auditors' Liability and the Need for Increased Accounting Uniformity*, 30 LAW & CONTEMP. PROB. 898, 906-07 (1965).

235 *Id.* at 909, 916-17.

236 H.L. Green v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960).

237 266 F. Supp. 180 (S.D.N.Y. 1967).

abetted" in defrauding the plaintiff. But the court noted that previously a defendant had been held liable under rule 10b-5 where it remained inactive in the light of a claimed duty to make disclosure, and where it knew that its inaction adversely affected those to whom that duty was owed.[238] Although the court was not certain that the same decision would result in the absence of an allegation of conspiracy or of aiding and abetting, which distinguished the case before it from other cases, it noted the "novel and difficult issues" raised, and found a need to develop further facts. The defendant did not fit into the usual categories of persons held liable under rule 10b-5 (*i.e.*, insiders, broker-dealers, issuers and aiders and abettors), and the "central issue" was whether the defendant could be held liable when it "did not directly gain from its failure to disclose its discovery of the falsity of the financial statements."[239] The motion to dismiss was denied by the court, without prejudice to the renewal of the motion at trial.[240]

The essence of the accounting firm's alleged violation was: (1) its knowledge of the falsity of its previously certified statement, (2) its duty to reveal that knowledge, (3) its failure so to reveal, and (4) its awareness of the effect of its silence. But the court was not convinced that even if all these elements were proved, liability would have been established. Clearly, however, there could be no liability without these factors.[241] Moreover, the omission must have related to a material fact and must have caused the harm alleged.[242]

The independent accountant does not stand to profit personally from his errors, and the possible consequences of allowing recovery liberally can be severe. Conscious error or severe departure from standards of due care and auditors' responsibilities should be a pre-

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238 *Id.* at 192; Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963). More recently, the issuer was held liable as an aider and abettor when, with knowledge of fraudulent activities in the market affecting its stock, it remained silent. Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966).

239 Fischer v. Kletz, 266 F. Supp. 180, 190 (S.D.N.Y. 1967); *see* Note, *Securities—Rule 10b-5—Accountant Held to Duty to Disclose Material Errors in Certified Financial Report Discovered Subsequent to Filing,* 43 N.Y.U.L. REV. 208 (1968).

240 Fischer v. Kletz, 266 F. Supp. 180, 194 (S.D.N.Y. 1967).

241 The SEC, in an amicus curiae brief, summarized its understanding of the liability as follows: "Failure by an accountant to disclose that financial statements of a company which it has certified are false when it has become aware of the fact is, under Rule 10b-5(3), an act or course of business which operates as a fraud on persons in connection with the purchase or sale of securities of that company." Memorandum of SEC at 7, Fischer v. Kletz, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,844, at 95,889 (1967).

242 Note, *Accountants' Liabilities for False and Misleading Financial Statements,* 67 COLUM. L. REV. 1437 (1967).

requisite of liability.[243]

Honest errors of judgment with respect to product line reporting would seem to lack the requisites to impose liability on the accountant. Even a failure to report product line results, when based on the accountant's honest mistakes of judgment, would seem to be lacking the necessary basis for a claim under rule 10b-5 in that it could not be asserted that the accountant had become *aware* that the statement was false. Whatever danger which might exist from defective product line reporting would result from the certification of a financial statement in disregard of appropriate accounting principles.

Liability from Uncertified Documents

Unlike sections 11 and 18, the liability of an accountant under rule 10b-5 might extend beyond that based upon certified statements. If product line reporting appears in a portion of the financial statement to which the certificate does not pertain, or if such results are reported in a document issued by management, there is no representation by the accountant with respect to such information. Yet, the liability of the accountant under rule 10b-5 in connection with the management's representations was dealt with as a separate issue in *Fischer v. Kletz*.[244]

In that case, Yale Express Company published interim financial statements that were not certified and which the plaintiff claimed were false and misleading, and which he further asserted the defendant accounting firm knew were false and misleading. The plaintiff asserted that there was liability under rule 10b-5, although no claim was made under common law.[245] The court held that there was no basis in law for imposing upon the accountant a duty to disclose its knowledge of the falsity of the interim financial statement.[246] But, although the court expressed doubts on the matter, it found that there was an issue as to whether the firm had rendered substantial "assistance or encouragement"[247] to Yale's allegedly ille-

243 *Cf.* Comment, *Accountants' Liability for Nondisclosure of Post-Certification Discovery of Error*, 116 U. PA. L. REV. 500, 509 (1968).

244 266 F. Supp. 180 (S.D.N.Y. 1967).

245 The SEC took no position on this aspect of the complaint. However, elsewhere in its brief it said that the accounting firm's "legal duty to public investors arises from its certification of Yale's financial statements included in the 1963 annual report and in the Form 10-K filed with the Commission." Memorandum of SEC at 4, Fischer v. Kletz, [1966-1967 Transfer Binder], CCH FED. SEC. L. REP. ¶ 91,844, at 95,888 (1967). Plaintiff, in its brief, contended that the accounting firm was liable under section 10(b) of the 1934 Act "as an aider and abettor of management's 1964 violations of that statute." Brief for Plaintiff at 7a, Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

246 Fischer v. Kletz, 266 F. Supp. 180, 195 (S.D.N.Y. 1967).

247 *Id.* at 197; *see* RESTATEMENT OF TORTS § 876 (1938).

gal conduct. Therefore, the court refused at this early stage of the litigation, at a time when discovery was barely underway, to dismiss the complaint.[248]

Yale Express' practice of consulting its auditors before publishing an unaudited financial statement is fairly typical. Matters in a prospectus, annual report, or proxy statement which relate to financial data often are examined by auditors although no opinion is expressed with respect to those matters.[249] However, the auditors will, on occasion, make suggestions to management dealing with the presentation of the material. This is similar to the conduct characterized by the plaintiff in *Fischer v. Kletz* as "substantial assistance or encouragement" which, in that case, consisted of a recommendation to use internal figures when the auditor "did not know that such figures were accurate."[250] While the court refused to dismiss the complaint, the strong impression remains that if the plaintiff were unable to make a stronger case than he had made thus far, the complaint would be dismissed on this count as failing to state a cause of action.

If what has just been described, then, constitutes the substance of the auditor's involvement with product line results issued by management, there should be no serious threat of auditor's liability. This comment is both a prediction and a hope. It would be unfortunate if the zeal of aggrieved investors were permitted to cause heavy penalties to auditors who seek to guide management in the presentation of meaningful information, but who make no examination of the underlying data. They are neither paid to do so nor do they represent to anyone that they have done so. For purposes of assisting management, the auditors should be able to assume that the data furnished them is accurate. If the threat of liability is increased, however, the alternatives are clear—and unfortunate. Either auditors will seek substantially higher fees for performing much wider duties, or they will refuse to assist management. In either case the loss will be most keenly felt by investors.

One of the unaudited items upon which independent accountants might work is the earnings statement that an issuer customarily will publish covering the twelve month period following the effective date of a 1933 Act registration statement. The effect of such publication is that if any person acquires securities sold pursuant to a registration

[248] Fischer v. Kletz, 266 F. Supp. 180, 197 (S.D.N.Y. 1967). There was a special factor present in this case arising from the fact that the accounting firm had undertaken a special study of the company. *Id.* at 184.

[249] 1 L. Loss, SECURITIES REGULATION 327 n.26 (2d ed. 1961); WHEN CORPORATIONS GO PUBLIC 141 (Israels & Duff eds. 1962); MAUTZ, *supra* note 19, at 141.

[250] Brief for Plaintiff at 25, Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

statement after the publication of the earnings statement, he cannot recover under section 11 of the 1933 Act by reason of an untrue statement unless he can prove that he relied thereon.[251] There is no requirement of certification of the earnings statement, nor is the form prescribed, but accountants customarily review the manner of presentation and the contents of the statement.[252]

The earnings statement is not filed with the Commission and therefore is not subject to Regulation S-X.[253] But the purpose of the statement is to reduce the risk of liability in a public offering. Its use in this manner makes it a "device" used "in connection with the purchase or sale of [securities]."[254] Therefore, it falls within the scope of rule 10b-5.

Unlike the accounting firm in *Fischer v. Kletz,* the accountant has a personal stake in publishing an earnings statement, because the publication will make it more difficult to impose liability on any of the potential defendants under section 11, including the accountants.[255] However, no special responsibility of the accountant to the marketplace can be attached to the statement, as it is neither certified nor filed with the Commission. Hence, the accountant need not fear implication in any civil liability resulting from the publication of this statement unless he gives "substantial assistance or encouragement" to its preparation. Merely reviewing the statement should not be viewed as "substantial."[256]

Product line reporting will probably be necessary in the section 11(a) earnings statement to the same extent that it would be required in the prospectus if it is to have the desired effect of forcing a plaintiff to show reliance. Even if the original prospectus did not show product line results, changes in the affairs of the company might make it necessary to do so. Thus, a requirement of product line reporting may make it slightly more difficult to build an obstacle to section 11 liability, but the process of creating that obstacle probably will not by itself present any significant risks to the accountant.

Conclusion

In a real sense, the most important legal implication of extended financial reporting by diversified companies which can be drawn from

[251] Securities Act of 1933 § 11a, 15 U.S.C. § 77k(a) (1964) (last sentence).

[252] 3 L. Loss, Securities Regulation 1725 (2d ed. 1961); L. Rappaport, SEC Accounting Practice and Procedure § 23.3 (rev. 2d ed. 1966).

[253] 17 C.F.R. Part 210 (1968).

[254] *Id.* § 240.10b-5.

[255] In Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), the court said it placed no weight on the lack of an allegation of gain by the accountant, but said that it raised an interesting question. *Id.* at 193.

[256] *Id.* at 197.

this analysis is the freedom from serious legal implications. It was stated at the outset that the thrust of this inquiry was to test the gravity of the risks of the additional responsibilities which would be created by product line reporting. Serious burdens and risks exist under present law and practice but, from a legal standpoint, neither the risks nor the burdens would be appreciably increased by a requirement of product line reporting. Thus, the potential liability of corporations or of auditors is not a persuasive argument against new requirements for financial reporting.

This conclusion by no means resolves the larger question of whether, or in what form, such requirements should be adopted, but it does compel us to examine the issue on different grounds. Initially we must determine what can be gained from product line reporting. While that question is not essentially a legal one, lawyers are not unconcerned with the answer. It must be emphasized, however, that the efficacy of any regulatory change must be tested by its economic impact as well as by its legal one.

As noted earlier,[257] a convincing case has been made for extended reporting. There is a growing tendency toward the creation of large diversified companies. These conglomerate entities are more common and more important in our economy today than ever before. Under existing reporting practices, investors may be receiving significantly less information than the federal securities laws consider essential. If this is true, then some modification or adaptation of our methods of reporting is in order. Again, it is important for lawyers to consider the power under existing law to accomplish this. Much will depend on the manner in which the SEC acts upon the problem.

The SEC has pursued a desirable approach to this problem by soliciting and awaiting the views of interested private groups before acting. Obviously, the Commission will consider carefully Dr. Mautz's findings, and those of other studies, before it acts. Not every problem facing a government agency can be solved in this manner, but it is laudable that when the opportunity presents itself it is utilized.

At the same time, financial executives and the accounting profession must turn their attention to improvements in the financial reporting of diversified companies. A further development in the practice of accounting and financial reporting is needed to meet changing conditions. The goal should be the attainment of a level of proficiency whereby auditors can confidently certify management product line breakdowns and allocations of joint costs.

A sure way to sabotage the federal securities laws is to regard them as fixed and immutable and to ignore changing times. It is en-

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257 See text accompanying notes 12-46 *supra*.

tirely appropriate that the Commission's proposal on product line reporting be carefully examined, and, if found to be unnecessary or deficient in some respect, be rejected. However, the argument of some executives and accountants has a nostalgic ring of the 1930's. Dr. Mautz found that much of the opposition by business executives to extended reporting stemmed from a desire to keep the rules of the game the same. In answer to this opposition, he observed:

> [T]he rules are changing, however. As a matter of fact, the game is changing, partly due to the executives' own activities. The formation of diversified companies in itself changes the environment in which management lives. In many ways management becomes a victim of its own initiative and success. Because business management does well, society continues to take an increasing interest in its activities. The current interest in the financial reporting of conglomerate companies is but one indication of this increasing awareness.[258]

It should be possible to fulfill the needs of investors without imperiling management or creating impossible tasks for accountants. A cooperative effort on the part of all groups concerned with making the federal securities laws serve their purpose is needed to accomplish the task. The Commission must recognize and take account of the difficulties in new proposals and the private sector must recognize and take account of the needs of investors in a changing economic climate. Hopefully, as Chairman Cohen testified, "the result will be a higher quality of financial information to investors and to others who are interested in the performance of American industry."[259]

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258 MAUTZ, *supra* note 19, at 79-80.

259 *Economic Concentration Hearings*, *supra* note 17, pt. 5, at 1988 (1966).

Addendum

Following the completion of this article, the SEC announced proposed amendments to the registration forms under the 1933 and 1934 Acts which would require disclosure of product line results.[260] The highlights of the proposal are:

(1) Companies would be required to show the approximate contributions to sales and/or revenues, and to net income (excluding extraordinary items), for each of the last five years of "each class of related or similar products or services"[261] which contributed 10 percent or more to total sales or revenues or to total pre-tax net income during either of the two preceding fiscal years. If it were not practicable to show contribution to net income, the company would be required to show contribution to earnings most closely approaching net income or loss.

(2) If practicable, companies would indicate the amount of assets employed in each segment of the business for which separate operating results were shown.

(3) If 10 percent of sales or revenues were derived from overseas operations, from government procurement or from any single customer, similar data as to revenues, earnings and assets employed with respect to such source, as well as for those separate categories of products or services within each such source which contributed 10 percent to total sales and revenues or net income, would be presented.

(4) The determination of separate reporting segments would be left to management and would be based on consideration of different rates of profitability, degrees of risk, growth opportunities and all other relevant factors. A brief description of the basis of classification would be required.

(5) Since contributions to net income would be shown if possible, all cost items would have to be allocated among the various segments. This requirement rejects the notion of "defined profit," of which Chairman Cohen had spoken earlier.[262] Perhaps a "defined profit" approach might be employed when it would be impracticable to show contribution to net income. But if the allocation of joint costs or the pricing of intra-company transfers would affect materially the separately stated income of any segment, the method of allocation would have to be shown. Nonetheless, segments of a business between which substantial amounts of products or services were transferred could be consolidated for reporting purposes.

[260] SEC Securities Act Release No. 4922 (Securities Exchange Act Release No. 8397) (Sept. 4, 1968).

[261] *Id.* at 1-3.

[262] See note 17 *supra* and accompanying text.

(6) Disclosure would be made in the text of Forms S-1 and S-7 under the 1933 Act and Form 10 under the 1934 Act, all under the captions describing the registrant's business. No presentation would be required in any financial statements.

The amendments would affect only companies which are offering securities under a 1933 Act registration statement or which are first registering under the 1934 Act, either because they have just listed their securities on a national securities exchange or because they have just attained the requisite size.[263] To reach the annual reports of other companies will require changes in the annual report on Form 10-K or under the proxy rules. This may be forthcoming. The Commission's release announcing the proposed changes states that "[c]omparable amendments to other disclosure requirements have been deferred pending the completion of the study which is currently being made by the Commission[264] of disclosure under the Securities Exchange Act of 1934."[265]

Most of the problems created by the Commission's rules have been anticipated and discussed in the literature. The Commission's release acknowledges that it has considered Dr. Mautz's study and the writings of the AICPA and the National Association of Accountants, among others. Mautz's impact is seen clearly, for example, in the criteria for identifying the segments for which separate reports of operating results would be required[266] and in the Commission's decision to leave the application of these criteria to management.[267]

Several new problems appear, however. The Commission seeks to have companies show the amount of assets employed in each significant segment, contrary to the author's expectations.[268] Serious accounting problems, to which little attention has been devoted as yet, will be involved in implementing this requirement. It is in recognition of the difficulties, perhaps, that the Commission has asked that this information be furnished "if practicable." The information will be useful, however. For example, only with such information can one compute return on investment or turnover of inventory, both of which are important tools in investment analysis.

More surprising is the proposed requirement that companies disclose information with respect to large single customers. If adopted, this requirement certainly would increase the problems faced

[263] See note 57 *supra*.

[264] See SEC Securities Act Release No. 4885 (Nov. 29, 1967) (announcing appointment of the Wheat Study Group).

[265] SEC Securities Act Release No. 4922 (Securities Exchange Act Release No. 8397) at 2 (Sept. 4, 1968).

[266] See note 37 *supra* and accompanying text.

[267] See note 38 *supra* and accompanying text.

[268] See note 27 *supra* and accompanying text.

by accountants and managers and would seem to justify management's fears of competitive effect. The Commission is something less than sure of itself in this proposal, however. The release announcing the change stated that "[t]he Commission believes that such disclosure with respect to a single customer merits consideration and invites comments thereon."[269]

In the main, the Commission has proceeded cautiously. As for the subject matter of this article, the Commission's proposals do not require any significant revision of its comments or conclusions with respect to the legal impact or the overall desirability of expanded disclosure.

[269] SEC Securities Act Release No. 4922 (Securities Exchange Act Release No. 8397) at 1 (Sept. 4, 1968).